Supreme Court, U. S.
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No. 76-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute involved	2
Statement	3
Reasons for granting the writ	8
Conclusion	17

TABLE OF AUTHORITIES

CASES:

American Realty Trust v. *United States*, 498 F.2d 1194 (4th Cir. 1974) 8, 12
Arkansas Bank and Trust Company v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963) 12
Benton v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952) 12
Breece Veneer and Panel Co. v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956) 12
Commissioner v. *Culbertson*, 337 U.S. 733 (1949) 13
Commissioner v. *Duberstein*, 363 U.S. 278 (1960) 14
Commissioner v. *First Security Bank of Utah*, 405 U.S. 394 (1972) 9
Cubic Corporation v. *United States*, (9th Cir. August 20, 1976) 9, 13
First Agricultural National Bank v. *State Tax Commission*, 392 U.S. 339 (1968) 5
Helvering v. *Clifford*, 309 U.S. 331 (1940) 13
Helvering v. *Lazarus & Co.*, 308 U.S. 252 (1939) 11
Horton v. *U.S. Steel Corp.*, 286 F.2d 710 (5th Cir. 1961) 17
Kearney & Trecker Company v. *United States*, 195 F. Supp. 158 (E.D. Wis. 1961) 12
Lockhart Leasing Company v. *United States*, 446 F.2d 269 (10th Cir. 1971), affirming 54 T.C. 301 (1970) 13

	Page
Lundgren v. *Freeman*, 307 F.2d 104, 114 (9th Cir. 1962)	17
Meiselman v. *Commissioner*, 300 F.2d 666 (4th Cir. 1962)	12
Northwest Acceptance Corporation, 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974)	13
Oesterreich v. *Commissioner*, 226 F.2d 798 (9th Cir. 1955)	12
Pacific Terminal Co. v. *Interstate Commerce Commission*, 219 U.S. 498 (1911)	13
Reade Manufacturing Company v. *Commissioner*, 32 TCM 1225 (1973)	12
Stirman v. *Cravens*, 33 Ark. 376 (1878)	16
Van Zandt v. *Commissioner*, 341 F.2d 440 (5th Cir. 1965)	10
Western Contracting Corporation v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959)	12
STATUTES, RULES AND REGULATIONS:	
Internal Revenue Code § 48(d)	13
Internal Revenue Code § 163(a)	2, 14
Internal Revenue Code § 167(a)	2, 3, 11
28 U.S.C. § 1254(1)	2
Federal Rules Civ. Proc., Rule 52(a)	17
MISCELLANEOUS:	
Rev. Rul. 55-540, 1955-2 C.B. 39	12
Rev. Rul. 68-590, 1968-2 C.B. 66	12
Rev. Proc. 75-21, 1975-1 C.B. 715	12
Rev. Proc. 75-28, 1975-1 C.B. 752	12
Rosenberg and Weinstein, "Sale-Leasebacks: An Analysis of These Transactions After the Lyon Decision", 45 Journal of Taxation 146, 147 n. 1 (1976)	12

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Petitioner, Frank Lyon Company, prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Eighth Circuit reversing a judgment of the United States District Court for the District of Arkansas.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is not yet reported; it is set forth as Appendix B, *infra* pp. 15a-30a. The opinion of the District Court, as supplemented, is not reported; it is set forth as Appendix A, *infra* pp. 1a-14a.

JURISDICTION

The judgment below was entered on May 26, 1976 (Appendix C, *infra* p. 31a). On August 6, 1976, the Court of Appeals denied a timely petition for rehearing (Appendix D, *infra* pp. 32a-33a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the petitioner was entitled, as owner-lessor of a building to deduct on its Federal tax returns depreciation with respect to that building, and interest which it paid on loans on which it was liable.

2. Whether the court of appeals erred in setting aside the factual and legal judgment of the district court that the petitioner was entitled to the interest and depreciation deductions, on the basis of the court of appeals' own conclusion that the "cumulative effect" of otherwise ordinary lease features rendered the ownership interest of Lyon "too unsubstantial" to allow Lyon to claim depreciation and interest deductions.

STATUTE INVOLVED

Section 163(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 167(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

STATEMENT

This case arises out of the sale and leaseback of a bank building between Frank Lyon Company ("Lyon"—or petitioner) and Worthen Bank & Trust Company ("Worthen"), a bank located in Little Rock, Arkansas. The terms of that agreement were the result of arms-length bargaining between the parties, and the overall structure of the arrangement was dictated by federal and state banking regulations with which Worthen was bound to comply.

Worthen began to plan construction of a new multi-story bank and office building in 1965. Initially Worthen planned to finance, build, and own the project itself at a total cost of $9,000,000 for the site, the building, and an adjoining parking facility.

This initial plan was abandoned for two reasons.

(1) Worthen found itself unable to raise the necessary funds because of interest rate limitations imposed by state law; it had planned on a $5 million conventional mortgage and $4 million in debentures, but Arkansas law forbade Worthen (then a state bank) to pay more than six percent on debentures it might issue, and the bonds were not marketable at that rate.

(2) Federal Reserve Regulations required Reserve Board approval if the total investment in bank premises exceeded capital stock; the Reserve system indicated that they would not approve of

Worthen owning the $9 million facility, either directly or through a subsidiary, because Worthen's capital stock was only $4 million.

Worthen then sought to develop a method which would provide Worthen with the use of the building, satisfy the requirements of federal and state regulators, and attract the necessary capital. It was concluded that this could be accomplished by a sale of the building to an independent outside investor, and a leaseback of the building to Worthen for its occupancy and use.

The State Bank Department and the Federal Reserve System approved a proposal for the sale and leaseback of the projected building under which Worthen would retain control of the adjacent parking facility but would sell the bank building and land for $7,500,000 and lease it back from the buyer. The State Bank Department required that Worthen have an option to purchase the leased property at the end of the fifteenth year of the lease at a price set in the agreement, and the Federal Reserve System required that the bank building be owned by an independent third party.

A number of investors were interested in owning the building on this general basis and submitted proposals to Worthen. Lyon heard of the arrangement at this time and submitted its first proposal on October 30, 1967.[1]

Taking the most favorable elements of various bidders' proposals (including a suggestion by Eastman Dillon, Union Securities Co. that sale of the land under the bank be eliminated from the sale to simplify establishment of equitable option prices), Worthen prepared and submitted to the bidders a "Specification for Sale-Leaseback of Worthen Bank and Office Building." Anxious to acquire the building, Lyon proposed a reduction of rent of $21,000 per year for the first five years. Lyon's proposal was accepted by Worthen, and Lyon was approved as an acceptable borrower by First National City Bank (FNCB) and New York Life Insurance Company.[2]

[1] For competitive reasons, Worthen desired to get the building in operation as soon as possible and it had begun construction on a cost-plus basis on September 15, 1967, before the buyer was chosen.

Final negotiations on terms began in December 1967 and were not completed until May 1968. Intensive discussions about all terms of the arrangement were carried on between Lyon and Worthen, with FNCB and New York Life participating on the financing issues. When the negotiations concluded, FNCB and New York Life required that the final terms be submitted to State and Federal Bank regulators for final approval. The regulators approved the terms.

Under the agreement, Worthen gave Lyon a ground lease for 76 years and 7 months on the site of the bank building, and sold the building to Lyon piece by piece, as it was completed,[3] for a total price of $7,640,000.

[2] FNCB's commitment letter stated the explicit understanding that "an acceptable real estate company" (Lyon) would be "the actual borrower" and that Worthen Bank "will not actually be guaranteeing our loan." The commitment letter of New York Life Insurance Company was addressed to Lyon.

[3] This arrangement was made because purchase of materials by the bank (by then a national bank) was not subject to Arkansas sales tax, pursuant to this Court's decision in *First Agricultural National Bank* v. *State Tax Commission*, 392 U.S. 339 (1968); and sale of the building elements to Lyon was not subject to sales tax, since it was a sale of real estate. The Federal Reserve System would not permit Worthen to complete the building and then sell it to Lyon because Worthen's investment in bank premises could at no time, however short, exceed its capital stock.

Lyon then leased the building back to Worthen for a primary term of twenty-five years with options to extend the lease for eight additional five-year terms.[4] To cover the purchase price, Lyon invested $500,000 out of its own working capital and $7,140,000 which it borrowed from New York Life on the permanent loan. At the end of the 11th, 15th, 20th and 25th years of the lease, Worthen had the option to purchase the building at prices agreed on in the lease.[5]

The lease was a "net lease," under which Worthen was charged with the responsibility for operating the building, for insurance and repairs, and for keeping the premises "in good order and condition: except for reasonable wear and tear."

In December 1969, Worthen took possession. On Lyon's 1969 tax return, Lyon accrued one month's rent in income and deducted one month's depreciation, and interest on the building. The Commissioner audited Lyon's return and determined without explanation

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[4] The rent schedule for the building was as follows:

First 11 years of the lease	$582,224
Years 11-25	613,156
Option Periods (Years 26-65)	300,000

The ground rents to be paid to Worthen by Lyon were $50.00 per year for the first 26 years 7 months and thereafter:

12/1/94 thru 11/30/99 (5 years)	$100,000
12/1/99 thru 11/30/04 (5 years)	150,000
12/1/04 thru 11/30/09 (5 years)	200,000
12/1/09 thru 11/30/34 (25 years)	250,000
12/1/34 thru 11/30/44 (10 years)	10,000

[5] The option schedule was as follows:

11/30/80 (after 11 years)	$6,325,169.85
11/30/84 (after 15 years)	5,432,607.32
11/30/89 (after 20 years)	4,187,328.04
11/30/94 (after 25 years)	2,145,935.00

that Lyon "is not the owner for tax purposes of any part of the Worthen Building," disallowed Lyon's depreciation and interest deductions, and adjusted Lyon's income accordingly.

Lyon paid the resulting deficiency. After a refund claim was disallowed, Lyon brought suit in the United States District Court for the Eastern District of Arkansas.

The district court held that the petitioner's depreciation and interest deductions were allowable. The court concluded that the legal intent of the parties had been to create a bona fide sale and leaseback, and that the arrangement substantively achieved this goal. The court rejected the notion that Worthen was acquiring an equity in the building through its rental payments, finding that the rents were reasonable throughout the period of the lease, and that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates; the court concluded that it was highly unlikely as a practical matter that any purchase option would ever be exercised (App. 2a, 6a).

In light of the bid competition for ownership, the district court rejected any negative inference to be drawn from the fact that the rentals (or rentals combined with options) were only enough to amortize the New York Life loan and to pay Lyon a six percent return on its equity investment, on the assumption that the options would be exercised, contrary to the court's finding. (App. 13a, 10a.) Likewise the court rejected any inference built on the fact that it was a "net" lease which, the court noted, is a common form of long-term real estate lease (App. 13a, 12a).

Despite these clear findings, the court below reversed the decision of the district court. In its analysis, the court of appeals likened ownership for tax purposes to a "bundle of sticks" which represent the various benefits and burdens associated with ownership. The court focused on its perception (an erroneous perception, as we show below; see pp. 15-16, *infra*) that the agreement deprived Lyon of any prospect of realizing appreciation on its ownership through increased rentals, or sale to third parties, or condemnation, and left Worthen with effective control over the operation and disposition of the property—through the sixty-five years of the lease terms, including options, and beyond through its control of the underlying property. The court undertook its own evaluation of the facts, and adopted the conclusion that "the taxpayer [Lyon] totes an empty bundle" of ownership sticks, i.e., that Lyon's ownership interest was too insubstantial to support the claimed depreciation, despite the fact that Lyon retained all the risks and benefits if the options were not exercised, or if Worthen should become insolvent. Without much consideration, the court also disallowed the interest deductions on the same general basis.

REASONS FOR GRANTING THE WRIT

1. The arrangement in this case was a realistic one, made by the parties on an arms-length basis, and to meet legal requirements. Yet the court of appeals strikes it down on a retrospective determination that the taxpayer had no "significant ownership interest" (App. 30a) in the building. This decision is fundamentally in conflict with the decisions of the Court of Appeals for the Fourth Circuit in *American Realty Trust* v. *United States*, 498 F.2d 1194 (1974), where, on a similar set of facts involving a sale and leaseback, the court

held that the conclusions of the trier of the fact should be sustained, and with the decision of the Court of Appeals for the Ninth Circuit in *Cubic Corporation* v. *United States*, decided August 20, 1976, where the court likewise upheld a sale-leaseback, saying: "That the intent of the parties was to provide a legal means by which the counties [lessees] *could eventually* acquire title does not change a clear lease-option agreement into a contract of conditional sale." (Emphasis in original.)

Here, the petitioner, Lyon, a wholly independent company, was brought into the situation in order "to provide a legal means by which" Worthen could obtain the use of the building—using the words of the court in the *Cubic Corporation* case. The transaction necessitated ownership by Lyon, because Worthen could not legally own the building, and could not legally borrow the money needed for the construction of the building. Lyon made no loan to Worthen, and Worthen was not liable to Lyon, except for rent. For the court below to say that nevertheless Worthen was the owner of the building, and the borrower of the money, is to stand the transaction on its head, making it be something it could not be, and is contrary to the essence of this Court's decision in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972).[6]

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[6] In the *First Security Bank of Utah* case, the Commissioner attempted to allocate to the Utah bank certain commissions on insurance. This Court held the allocation invalid because banks could not legally earn or retain such income under banking law. Similarly, here the Government argues that Worthen owns the building and should take the depreciation although bank authorities have demanded that Worthen not own the property and have confirmed that Worthen does not own it under this arrangement. The situation with respect to the interest deduction is similar, since Worthen could not legally borrow the money, and yet is treated by the court below as the borrower.

2. The Government will doubtless say that there is no conflict because all cases in this area have their own facts, and so any decision may be distinguished on one ground or another. But this overlooks the important role of this Court in providing guidance and clarification to the lower courts, and to lawyers and government officials who are engaged in the administration of the tax laws. It is an appropriate function of this Court to provide such guidance on matters of basic principle in areas which are constantly recurring in tax administration and in the courts. This is especially true where the question is one of importance on which businessmen and lawyers need light in order that they may intelligently plan and carry out transactions on a basis of reasonable assurance without the inevitability of controversy and litigation with respect to each transaction.

Sale and leaseback arrangements have been widely used, and, as here, in many situations which do not involve any aspect of "sham" or "tax avoidance."[7] In this case, for example, there is no doubt that depreciation was sustained, and that interest was paid. The understanding that these items could be deducted by Lyon was a basis on which the negotiations between Lyon and Worthen were conducted. It made little or no difference to the Government which entity took the

[7] Cases involving *gift* leasebacks, often in intra-family situations, present a much greater danger of tax avoidance and wholly different policy considerations. *Cf. Van Zandt* v. *Commissioner*, 341 F.2d 440 (5th Cir. 1965). Here the transaction is a commercial one bargained out at arms-length, and the parties are subject to identical tax rates, so there is no effort to take advantage of a tax differential.

deduction as long as there was no double deduction.[8] If it had been known that these items were deductible by Worthen (which is the consequence of the decision below; see *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939)), the rental payments would have been adjusted accordingly. To deny these deductions now is to catch Lyon in a trap, and to give Worthen a windfall; the bargain which the parties made is scrambled without any substantive justification.

Typically, the sums involved in sale-and-leasebacks are substantial, and the complexity and variations of sale-leaseback arrangements reflect the fact that such transactions are devised to meet specific situations. Flexibility of form is an important part of the utility of the device, but uncertainty has often been the result. In the absence of a clearly understandable rule as to the tax consequences, the courts have seized on various mutually exclusive factors as determinative of tax treatment. A list of some of the cases which were cited by both the Government and the taxpayer below in

[8] There is no doubt that Lyon "sustained" depreciation. Under the lease, Worthen's obligation to maintain and repair the building, and its obligation to provide insurance, explicitly excluded "reasonable wear and tear," which is the statutory definition of depreciation under Section 167(a) of the Internal Revenue Code. The building gets older year by year, and Lyon sustains this loss unless Worthen exercises one of its options to buy the building. Yet the district court found explicitly that it was unlikely that Worthen would exercise its options (App. 2a, 6a).

Moreover, Lyon takes the risk of Worthen's continued solvency. In the event that Worthen could not make payments under the lease, Lyon would remain the owner of the building and have only the building to look to. This clearly shows that it is Lyon that sustains the depreciation. The fact that it receives rental payments in whatever amount, is irrelevant on the depreciation issue.

support of their contrary characterizations of the arrangement at issue in this case is given below.[9] The Internal Revenue Service has also wrestled with the problem inconclusively on a number of occasions. *Rev. Rul.* 55-540, 1955-2 C.B. 39; *Rev. Rul.* 68-590, 1968-2 C.B. 66; *Rev. Proc.* 75-21, 1975-1 C.B. 715; *Rev. Proc.* 75-28, 1975-1 C.B. 752.[10]

The consequence of the decision below—striking down a bona fide, arms-length transaction, involving no tax avoidance or sham—is to leave chaos in this area of tax law, calling out for this Court to provide oversight and guidance.

After a substantial number of lower court decisions have been made in a field like this, so that the area is "mature", it is appropriate for this Court to resolve the basic issues which have developed. Borrowing a phrase from another field, the failure to grant review in the face of a conflict in approach as sharp as that between the court below and that of the Fourth Circuit in *American Realty Trust*, and of the Ninth Circuit in *Cubic Corporation*, would be to leave the issues "capable of repetition, yet evading review". *Pacific Terminal Co.* v. *Interstate Commerce Commission*, 219 U.S. 498, 515 (1911).

[9] *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir., 1974); *Meiselman* v. *Commissioner*, 309 F.2d 666 (4th Cir., 1962); *Western Contracting Corporation* v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959); *Breece Veneer and Panel Co.* v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956); *Oesterreich* v. *Commissioner*, 226 F.2d 798 (9th Cir. 1955); *Benton* v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952); *Arkansas Bank and Trust Company* v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963); *Kearney & Trecker Company* v. *United States*, 195 F. Supp. 158 (E.D. Wis. 1961); and *Reade Manufacturing Company* v. *Commissioner*, 32 TCM 1225 (1973).

[10] *Rev. Proc.* 75-21 met with strong protest from the real estate industry. The Service indicated that Rev. Proc. 75-21 would not be generally applied to real property, but that "some if not many of the ruling guidelines should be applicable." See Rosenberg and Weinstein, "Sale-Leasebacks: An Analysis of These Transactions after the Lyon Decision," 45 Journal of Taxation 146, 147 n.1 (1976) (the authors characterize both the *Lyon* court and the IRS as "groping for guidelines").

The situation is comparable to that which existed in the field of short term trusts when this Court granted certiorari, and decided *Helvering* v. *Clifford*, 309 U.S. 331 (1940), and in the field of family partnerships, when this Court granted certiorari, and decided *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949). In each of these instances, after this Court clarified the basic principles, the decisions of this Court were followed by legislation by Congress, and there has been very little litigation or administrative controversy in either field ever since. In the absence of a clarifying decision by this Court, multiplication of litigation in the lower courts is inevitable, and apparently haphazard frustration of careful plans can be expected to continue.

This Court should grant review now in order to clarify the law and thus to facilitate bona fide tax planning in this area by businessmen and their counsel. An arrangement involving large sums of money and extending over a long period of time cannot be prudently planned on mere speculation as to how some future court will assess the allocation of interests which the parties have chosen.[11]

[11] That there is no substantial risk to the Government here is shown by the provision of Section 48(d) of the Internal Revenue Code, which expressly allows a lessor to pass on the investment credit to the lessee, as the parties may agree. As the Tax Court, and the Courts of Appeals for the Ninth and Tenth Circuits have indicated, investment credit and depreciation involve very similar questions of "ownership" from the viewpoint of tax policy. See *Northwest Acceptance Corporation*, 58 T.C. 836 (1972), *aff'd* 500 F.2d 1222 (9th Cir. 1974); *Lockhart Leasing Company* v. *United States*, 446 F.2d 269 (10th Cir. 1971), *affirming* 54 T.C. 301 (1970).

3. In its decision denying Lyon a deduction for interest paid, the court below has reached a result that is so clearly erroneous that it departs from customary standards in the administration of justice and calls for correction by this Court. Section 163 of the Internal Revenue Code specifically allows a deduction for "all interest paid or accrued within the taxable year on indebtedness". There is no dispute that Lyon borrowed money from First National City Bank and from New York Life Insurance Company, and paid interest on both loans. Lyon was the only borrower. Worthen was not liable on the loans; it could not legally undertake the loans. Worthen did not owe interest, and did not pay any interest. Whatever may be the merit of the "bundle of sticks" argument, and whatever may be the appropriate evaluation of the ownership interests in the property, there is no doubt on this record that Lyon was liable on the loans, and that it paid interest which it owed, and for which Worthen was not liable, and could not legally be liable. Worthen was under no obligation either to pay interest or to reimburse Lyon.

The action of the court below in denying the interest deduction cannot be justified on any theory, and should be summarily corrected. The effect of the decision of the court below on this question is to highlight the error in its decision on the depreciation question, and to emphasize the importance of a clarifying opinion by this Court on the basic problems involved in this case.

4. The decision below, in its treatment of the findings made by the district court, as trier of the facts, is contrary to this Court's decision in *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960).

In the present case, the trial court found that the rents were reasonable throughout the period of the

lease (App. 13a, 5a-6a), and rejected the notion that Worthen was acquiring an equity in the building through its rental payments. (App. 2a, n.2.) The trial court also found that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates. (App. 6a). The trial court further concluded that it was highly unlikely as a practical matter that any purchase option would ever be exercised. (App. 2a, n.2.) Finally, the trial court made the ultimate finding that this was in fact a sale and leaseback. Specifically, the Court said (App. 1a-2a):

> "After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws."

The dangers of the approach taken by the court of appeals, in itself undertaking to determine the facts—through its process of appraising the "bundle of sticks"—is clearly shown by its factually erroneous conclusion that the agreement here deprived Lyon of any prospect

of realizing appreciation on the property. In the first place, Lyon's basis for the property would be reduced by depreciation allowed, so that there would be appreciation, taxable to Lyon, if the options were exercised.

Moreover, the court has misapprehended at least three important factors in the situation:

> (1) Lyon has had a number of offers from other investors to purchase the building at a profit to Lyon, which offers were refused, not because of any restrictions in the agreements on the petitioner's right to sell, but because the petitioner thought it had a good investment. (11-R 378; Pltf. Ex. 51).
>
> (2) While it is true that Worthen will realize the appreciation, if any, in the value of the building in the event of *total* destruction *after* December 1, 1980, under the agreements it is Lyon rather than Worthen which will realize the appreciation in the event of *total* destruction or taking prior to December 1, 1980, and in the event of partial damage or partial condemnation at any time.
>
> (3) Worthen did not control the disposition of the property for 65 years through its various options and thereafter through its ownership of the land. The petitioner's retention of control of the building for ten years after the expiration of the building lease and at a fixed ground rent of only $10,000 per year was an important ownership interest not controlled by Worthen, and Worthen's alleged ownership of the building on the expiration of the 75-year ground lease is highly questionable under Arkansas law. See *Stirman* v. *Cravens*, 33 Ark. 376 (1878).

The petitioner does not ask this Court to evaluate these facts. It does contend that the court of appeals erred when it undertook to reexamine the facts which had been determined by the district court. The action of the court of appeals flies in the face of Rule 52(a) of the Rules of Civil Procedure which provides that:

> Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.

As Judge Brown said in *Horton* v. *U. S. Steel Corp.*, 286 F.2d 710, 713 (5th Cir. 1961), the findings "come here well armed with the buckler and shield of F.R. Civ. P. 52(a)." Nor should Rule 52(a) "be construed to encourage appeals that are based on the hope that the appellate court will second-guess the trial court." *Lundgren* v. *Freeman*, 307 F.2d 104, 114 (9th Cir. 1962).[12] The findings of the district court should not have been re-evaluated by the court below.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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November, 1976

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[12] Judge Duniway, speaking for the court in *Lundgren*, made it clear that the impact of Rule 52(a) applies to cases tried on the basis of documentary evidence as well as on issues of credibility, 307 F.2d at 113-115.

APPENDIX

APPENDIX A

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

No. LR-73-C-247

FRANK LYON COMPANY, *Plaintiff*

v.

UNITED STATES OF AMERICA, *Defendant*

June 11, 1975. Year 1969.

EISELE, *Chief Judge:*

Memorandum Letter Opinion

Gentlemen:

Circumstances will not permit the Court to file an elaborate memorandum supplementing the findings and conclusions that it made in open court at the conclusion of the trial. Nor is an elaborate memorandum necessary in this case.

There are no true factual issues remaining, and the parties are in general agreement as to the applicable law. They do disagree with respect to the inferences to be properly drawn from the evidence and have different opinions as to the application of the legal principals involved.

The Government contends that although the "form" of the transaction was a sale and leaseback arrangement, the "substance" amounted to a nonrecourse loan for federal tax purposes. The plaintiff, on the contrary, asserts that the transaction, for federal tax purposes, was in "substance" exactly what it was in "form", that is, a sale-leaseback.

After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time

the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws.

The defendant concedes that Worthen turned to the sale-leaseback arrangement because of the net capital requirements of the Federal Reserve Board. See footnote, page 1, Defendant's Supplemental Memorandum of Fact and Law, filed December 20, 1974. It is likewise clear from the evidence that Worthen was going with such an arrangement, one way or the other, before the plaintiff entered the picture.[1]

The theory of the defendant that the plaintiff "loaned" Worthen $500,000 is completely untenable, both in fact and law, as indicated by the Court at the conclusion of the trial. As there stated, it is most unlikely that Worthen will exercise the option at the end of eleven years, or, indeed, at the end of any subsequent option period.[2] Absent action by

[1] The Court senses that a controversy might not have arisen at all had Worthen concluded the same, identical, transaction with parties other than the plaintiff. The close relationship between the plaintiff and Worthen appears to have made a great impression upon Mr. Charles Richardson, the agent who wrote the report which started this case on its way to this Court.

[2] Worthen's future capital requirements and the option prices stipulated on the one hand and the reasonable rentals stipulated on the other make this quite clear. Because of the unlikelihood, the improbability, that the option will be exercised, there is no basis to the Government's contention that it is acquiring an equity in the property through its payment of rent.

Worthen, there is no way that plaintiff can obtain repayment of the so-called "loan".

Plaintiff holds the legal title to the building under Arkansas law and is for tax purposes, too, the owner thereof. It bears the burden of depreciation and obsolescence.

The defendant does not contest the unreasonableness of the rental charge for the building. The Court has already indicated in open court that the reasonableness of the annual rent under the ground lease was really immaterial because under the arrangement it was essentially a wash-out item.

The plaintiff had mixed motivations for wanting to enter into the transaction, in addition to receiving the benefits of the tax shelter involved: in addition to the good after-tax rate, the plaintiff had a need to diversify its holdings and a need to use its accumulated earnings. There was also the long-term return on the investment which could be expected when the mortgage indebtedness was retired.

At this time I direct the attorney for the plaintiff to prepare and submit to the defendant, for its approval as to form, a precedent judgment in conformity with this letter-memorandum and the factual findings and legal conclusions stated in open court at the conclusion of the case. The Court will also *consider* making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975. The precedent judgment shall be submitted by June 4, 1975.

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

Findings of Fact

1. During 1965, Worthen Bank & Trust Company ("Worthen") began to plan the construction of a new multistory bank and office building to replace its old bank building in Little Rock, Arkansas. About the same time Union National Bank of Little Rock ("Union") also began to plan the construction of a new bank and office building.

Adjacent sites were acquired by both banks on Capitol Avenue, separated only by Spring Street. It became a matter of competition and prestige between the two banks as to which bank would start and complete its building first.

2. Worthen initially planned to finance the estimated $9,000,000 cost of its site, new building and parking facility by selling $4,000,000 of debentures and using the proceeds to purchase $4,000,000 of capital stock of a wholly owned real estate subsidiary, which would then raise the remaining $5,000,000 through a conventional mortgage loan on the new premises. This plan was abandoned for two reasons. As a bank chartered under the laws of Arkansas, Worthen could not pay more than the then statutory limit of 6% on any debentures it might issue, and Worthen was unable to locate a purchaser of the proposed $4,000,000 of debentures at an interest rate of 6% or less. Further, under the provisions of Section 24A of the Federal Reserve Act, prior approval of the Board of Governors of the Federal Reserve System was required if the total investment in bank premises (including any investment in a real estate company holding title to the premises) exceeded Worthen's capital stock of $4,000,000, and Worthen was informed by staff employees of the Federal Reserve System that they would not recommend approval of the plan by the Board of Governors.

3. Worthen then proposed a new plan involving a sale and leaseback. Both the Federal Reserve Bank of St. Louis and the State Bank Department approved the new plan after required modifications, including a requirement by the State Bank Department that Worthen have an option to repurchase the building after 15 years. Thereafter Worthen conducted detailed negotiations with several investors, including Goldman, Sachs & Co., Eastman Dillon, Union Securities & Co., Stephens, Inc. and plaintiff, resulting in the preparation by Worthen of a "Specification for

Sale—Leaseback of Worthen Bank and Office Building", which incorporated the best features from Worthen's point of view of the proposals made by the various investors. These specifications were submitted to Stephens, Inc. and plaintiff, the two best bidders, and the proposal of plaintiff was accepted when plaintiff improved its bid by reducing the proposed rent $21,000 per year for the first 5 years.

4. Because of its race with Union to complete construction first and prior to the selection of the investor, Worthen obtained a verbal commitment from First National City Bank for interim financing and from New York Life Insurance Company for permanent financing, subject to the lenders' approval of the investor to be selected. Worthen also negotiated a cost-plus construction contract with the general contractors prior to the final selection of the investor. After plaintiff was selected as the investor, plaintiff, Worthen, New York Life and First National City Bank spent five months in hard arm's length negotiations and drafting before finalizing the documents reflecting the agreements between the parties.

5. Worthen leased to plaintiff for 76 years and 7 months the ground under the bank building, sold the building piecemeal to plaintiff for $7,640,000 as it was being constructed (to meet the requirement of the Federal Reserve Bank that the building not appear on Worthen's books), and then leased back from plaintiff the completed building for a primary term of 25 years, with options to extend the lease for 8 additional terms of 5 years. Plaintiff invested in the building $500,000 from its own working capital and $7,140,000 it borrowed from New York Life Insurance Company on the permanent loan.

6. The annual rent of $582,224 for the first 11 years of the building lease and $613,156 for the next 14 years is the exact amount required to amortize the New York Life loan during the 25-year primary term of the lease. The

rent on the building during the option periods totaling 40 years is $300,000 per year. The evidence reflected, and the Court finds, that the rent to be paid by Worthen during the term of the lease is reasonable, a fact not contested by the defendant.

7. Worthen was given the option to purchase the Worthen Building on the following dates at the following purchase prices:

11-30-80 (after 11 years)	$6,325,169.85
11-30-84 (after 15 years)	5,432,607.32
11-30-89 (after 20 years)	4,187,328.04
11-30-94 (after 25 years)	2,145,935.00

The option price at each date represents the unpaid balance of the New York Life note plus plaintiff's $500,000 plus 6% compounded interest. It also represents the negotiated estimate of plaintiff and Worthen as to the fair market value of the building on the option dates, which the Court finds to be reasonable. The defendant produced no witnesses to contest the reasonableness of the option prices.

8. There has never been any understanding or agreement between Worthen and plaintiff that Worthen will ever exercise any of its options to purchase. Because of Worthen's future capital requirements, the very substantial amounts of the option prices, the reasonableness of the net rents Worthen will be required to pay during the original and extended terms of the building lease and the economic return Worthen earns on its funds not invested in real estate, it is most unlikely and improbable that Worthen will exercise its option to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods.

9. The ground lease requires plaintiff to pay Worthen $50.00 per year for the first 26 years, 7 months (the length of the primary term of the building lease plus the construc-

tion period). Thereafter the annual rental under the ground lease will be as follows:

12-1-94 thru 11-30-99 (5 years)	$100,000.00
12-1-99 thru 11-30-04 (5 years)	150,000.00
12-1-04 thru 11-30-09 (5 years)	200,000.00
12-1-09 thru 11-30-34 (25 years)	250,000.00
12-1-34 thru 11-30-44 (10 years)	10,000.00

The government contends that the ground rent of $50.00 per year during the primary term of the building lease is unreasonably low and indicates that Worthen owns the building. The evidence clearly showed, and the Court finds, that the amount of the ground rent during the first 25 years of the building lease is immaterial: had the ground rent to be paid by plaintiff to Worthen been increased, the building rent to be paid by Worthen to plaintiff would have been increased by the same amount, resulting in a washout.

10. On an audit of plaintiff's income tax return for 1969, the Commissioner of Internal Revenue determined, without further explanation, that plaintiff is "not the owner for tax purposes of any portion of the Worthen Building. Therefore, the income and expenses related to this building are not allowable to you for Federal income tax purposes." Based upon this determination the Commissioner made the following adjustments to plaintiff's reported income:

1. Accrued rental income for 1 month from Worthen	$(48,527.01)
2. Accrued interest for 1 month owed to New York Life	40,162.50
3. Depreciation for 1 month on Worthen Building	51,618.79

4. Expenses during construction:

(a) Interest paid to FNCB .	$403,899.54	
(b) Legal expense	33,351.05	
(c) Title insurance	10,140.00	
(d) Audit expense	3,475.00	
(e) Telephone and travel ..	801.16	451,666.75
5. Accrued interest income		2,298.15
Total increase in reported income		$497,219.18

11. Based upon these determinations, the Commissioner assessed an income tax deficiency against plaintiff in the amount of $236,596.36, together with interest in the amount of $43,790.84, making a total deficiency assessment of $280,387.80. (This figure does not include other uncontested adjustments which are not involved in this case). Plaintiff paid the deficiency assessment and filed a claim for refund of the $280,387.20, which claim the Commissioner disallowed. Thereafter plaintiff filed this action to recover the $280,387.20, with interest.

12. The Government contends that, although the "form" of the transaction was a sale and leaseback arrangement, in "substance" Worthen owned the building; that plaintiff was a mere "conduit" of the interim loan from First National City Bank to Worthen and of the permanent loan from New York Life Insurance Company to Worthen; and that plaintiff "loaned" to Worthen the $500,000 which plaintiff invested in the building from its own working capital.

13. The plaintiff contends that for federal tax purposes the transaction was in "substance" exactly what it was in "form", i.e., a true sale and leaseback transaction, with the interim and permanent loans being in form and substance made to plaintiff rather than to Worthen.

Conclusions of Law

1. It was both the "subjective" and "objective" intention of the parties, as evidenced by their written agreements when read in the light of the attending facts and circumstances existing at the time the agreements were executed, that the transaction be a sale-leaseback with options to repurchase, exactly in accordance with the form and language of the documents evidencing the transactions. Any other view of the case would not only produce strange and untenable results but would be both unjust to plaintiff and contrary to the intent and purposes of the applicable federal tax laws. Western Contracting Corporation v. Commissioner, 271 F.2d 694 (8 Cir. 1959); Arkansas Bank and Trust Company v. United States, 224 F.Supp. 171 (D.C. Ark. 1963).

2. Plaintiff owns the Worthen Building, both under Arkansas law and for federal income tax purposes. Because of the improbability that plaintiff will exercise any of its options to purchase, there is no basis for the defendant's contention that Worthen is acquiring an equity in the property through the payment of rent. Since the parties in good faith actually intended to enter into a sale-leaseback transaction, Worthen will acquire an equity in the property only if and when it ever exercises any of its options to purchase. Until the option to purchase is exercised, plaintiff bears the burden of the depreciation and obsolescence of the building. Defendant did not question the method or rate of depreciation used by plaintiff. Plaintiff is entitled to deduct the depreciation claimed on the building in its 1969 return. Breece Veneer and Panel Company v. Commissioner, 232 F.2d 319 (7 Cir. 1956); Benton v. Commissioner, 197 F.2d 745 (5 Cir. 1952); Kearney & Trecker Company v. United States, 195 F.Supp. 158 (E.D. Wisc. 1961).

3. Plaintiff was not a mere "conduit" for loans to Worthen by First National City Bank and New York Life

Insurance Company, as contended by the defendant. Plaintiff was the borrower and sole obligor on the interim loan and on the permanent loan. The interim and permanent lenders made independent investigations of plaintiff's financial stability, negotiated with plaintiff for almost six months over the details of the loans and in all respects intended and treated plaintiff as the borrower. The fact that Worthen negotiated tentative commitments for the loans prior to the selection of plaintiff as the investor does not indicate that Worthen was the borrower; it simply enabled Worthen to attract more potential investors and to obtain a lower rent. The fact that the rents were no less than the amount required to amortize the permanent loan was a requirement of New York Life Insurance Company; the fact that the rents were no more is only a reflection of the relatively small initial equity required of the investor and of the intensity of the competition among the potential investors for the investment. Plaintiff is entitled to deduct the interest paid and accrued on the interim and permanent loans.

4. Plaintiff is entitled to allocate and deduct its expenses incurred in obtaining the interim loan and permanent loan over the lives of the respective loans to which they relate. Detroit Consolidated Theatres, Inc. v. Commissioner, 133 F.2d 200 (6 Cir. 1943); Anover Realty Corp., 33 T.C. 671 (1960). Plaintiff is entitled to allocate and deduct over the life of the building the expenses incurred in acquiring the building. Plaintiff and defendant have stipulated the proper allocation of such expenses.

5. Even if the Court had found that Worthen owned the building for federal income tax purposes and was entitled to the depreciation deduction, plaintiff would still have been entitled to deduct the interest it paid on the interim and permanent loans and to allocate and deduct the expense it incurred in obtaining the interim and permanent loans and title to the building. Rev.Rul. 72-543.

6. The theory of the defendant that plaintiff "loaned" $500,000 to Worthen is completely untenable, both in fact and in law. There was no obligation or agreement by Worthen to repay the $500,000 and no way plaintiff could force the repayment. The only way plaintiff could ever receive the $500,000 from Worthen would be through the exercise by Worthen of one of its options to repurchase, an event entirely within the discretion of Worthen and highly improbable. Consequently, the Commissioner erred in assuming that Worthen will exercise its option at the end of the eleventh year of the building lease, and in determining that plaintiff's anticipated $303,356 gain on the assumed exercise of the option is the equivalent of interest which plaintiff must accrue as income evenly over the first eleven years of the lease. Regulations 1.446-1(c)(ii).

7. The defendant placed considerable emphasis upon the fact that, assuming plaintiff exercised its option to purchase at the end of the first eleven years of the lease, plaintiff's deduction for depreciation on the building would generate an operating loss deductible against other income of the plaintiff which would result in the net tax saving to plaintiff of $312,220.45 over the eleven year period. (Defendant's Exhibit 6). Defendant argued that plaintiff's only reason for investing in the building was to obtain this tax saving, and that a device to minimize tax liability, with no additional business purpose, will be disregarded for tax purposes. Defendant's argument on this point is in error for several reasons. First, the evidence clearly reflects, and the Court finds, that plaintiff was motivated to enter into the transaction, not only because of the good current after-tax return offered by the investment, but because of plaintiff's need to diversify its holdings, the need to use its accumulated earnings to avoid a Section 531 tax, and the anticipated long-term return on the investment after the permanent loan was retired. Secondly, the form of the transaction was determined by Worthen within guidelines

established by banking law restrictions having nothing to do with tax motives; substantially the same terms had been negotiated with other potential investors before plaintiff entered the picture. The reality of the transaction for tax purposes cannot be unilaterally determined solely by plaintiff's intent or motives. Breece Veneer and Panel Company v. Commissioners, supra, at 323. Thirdly, it is highly unlikely that the option will be exercised at the end of the first eleven years of the lease, after which time the building lease will generate a substantial taxable income to plaintiff. Finally, the fact that plaintiff will receive a tax benefit during the early years of the investment is in keeping with the intent of Congress to stimulate investments in depreciable real estate through accelerated depreciation deductions; it does not suggest that the substance of the transaction was not in keeping with its form. Plaintiff has the legal right to decrease the amount of what otherwise would be his taxes by means which the law permits. Gregory v. Helvering, 293 U.S. 465 at 469 (1935).

8. The agreement of Worthen, as lessee under the Building Lease, to pay all taxes, insurance and maintenance on the building, to hold the lessor harmless from all claims arising out of lessee's use of the premises and to pay rent during the initial term in an amount sufficient to amortize the mortgage on the building are all terms which are quite common in long-term real estate leases. Such assumption by Worthen of the risks of operation normally borne by an owner did not make Worthen the owner of the building for tax purposes.

9. All of the other terms of the agreements among the parties and the surrounding circumstances which defendant contends are collectively sufficient to make Worthen the owner of the building for tax purposes are common in and consistent with a bona fide sale-leaseback with option to purchase, and do not, individually or collectively, make Worthen the owner of the building for tax purposes.

Supplementary Findings of Fact and Conclusions of Law

In open court at the end of the trial and by Letter Memorandum of May 16, 1975, the Court made certain findings of fact and conclusions of law in this proceeding. In the Letter Memorandum of May 16, the Court indicated to the attorneys for the parties that it would "consider making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975." The plaintiff submitted "Proposed Findings of Fact and Conclusions of Law" prior to May 30, 1975. Defendant has submitted none.

Although the Court usually does not make findings with respect to uncontested or noncontroverted facts such as those contained in the "Proposed Findings of Fact" 1 through 7 and 10 through 13, it will supplement its findings of fact in this case by adopting said proposed findings since the facts stated are true and were never really at issue in the case. The Court has already made findings of fact in the matters referred to in "Proposed Findings" numbered 8 and 9. The proposed findings are accurate, but are simply a restatement of the facts previously found by the Court.

The "Proposed Conclusions of Law" submitted by the plaintiff are accurate statements insofar as they refer to the law involved, but most of the proposed additional conclusions are unnecessary in the light of the Court's rulings. The Court will, however, adopt "Proposed Conclusions" numbered 4, 6, 8 and 9 as supplements to, or a further statement of, its prior conclusions.

For the purpose of identifying the supplementary findings of fact and conclusions of law proposed by the plaintiff, the Court attaches hereto, and makes a part hereof, the submission by the plaintiff entitled "Proposed Findings of Fact and Conclusions of Law". [App. 3a-12a, *supra*.]

Judgment will be entered this date pursuant to the rulings in open court, the Letter Memorandum of May 16, 1975, and the findings of fact and conclusions of law adopted herein.

JUDGMENT

Findings of fact and conclusions of law having been entered in the above-styled case, judgment in conformity thereto is hereby entered in favor of plaintiff in the following amounts with interest thereon from the dates indicated:

$32,624.32 with interest thereon from March 15, 1969;
$231,871.26 with interest thereon from March 15, 1970;
$43,790.84 with interest thereon from April 19, 1973.

Dated this 11th day of June, 1975.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 75-1615

FRANK LYON COMPANY, *Appellee*,

v.

UNITED STATES OF AMERICA, *Appellant*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF ARKANSAS

Submitted: February 13, 1976.

Filed: May 26, 1976.

Before BRIGHT and HENLEY, *Circuit Judges*, and REGAN, *District Judge*.*

BRIGHT, *Circuit Judge*.

This income tax controversy arises from a series of complex documents which purport to effect a sale of a bank building (not including the underlying land) by a bank to taxpayer, Frank Lyon Company, and a 65-year leaseback with options to purchase the building by the bank. The question presented is whether these transactions vested taxpayer with ownership of the building for tax purposes so as to entitle taxpayer to deduct from its income the tax shelter benefits of depreciation of the building and interest paid on the building mortgage loan. The Commissioner of Internal Revenue ruled that taxpayer did not possess ownership of the building for tax purposes and denied taxpayer these tax advantages. Taxpayer paid the deficiency and successfully sued for a refund in the United States District Court for the Eastern District of Arkansas. The Government thereafter brought this appeal. We reverse, and sustain the Government's position.

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* JOHN K. REGAN, *United States District Judge, Eastern District of Missouri*, sitting by designation.

Taxpayer acquired its interest in the building in question from the Worthen Bank and Trust Company of Little Rock, Arkansas (Worthen). In 1965, Worthen entered negotiations for the purchase of land in downtown Little Rock on which to construct a new bank building. When such land was purchased, Worthen drew up plans for the new building and entered into construction contracts.

Worthen initially intended to finance the construction itself and to retain ownership of the building. However, federal and state banking regulations forbade Worthen to carry such an expensive building as an asset on its own books. Worthen thereupon decided to adopt a sale-leaseback arrangement using a newly-formed, wholly-owned corporate subsidiary to hold title to the building. However, Worthen learned that debt financing for such a subsidiary could not be arranged.

In 1967, Worthen informed banking authorities that it had decided upon a sale-leaseback arrangement with an independent investor. This approach satisfied the applicable state and federal banking regulatory agencies. Worthen then obtained a verbal commitment from First National City Bank of New York (FNCB) for interim construction financing. A similar commitment for long-term financing of the building was obtained from New York Life Insurance Company. The long-term financing was conditioned upon approval by New York Life of the party nominated by Worthen to hold title to the building.

Worthen then commenced arm-length negotiations with several investors. Taxpayer Frank Lyon Company learned of these negotiations and informed Worthen of its interest. Frank Lyon, chairman of the board of taxpayer company, served on Worthen's board of directors and Frank Lyon Company does substantial business with Worthen.

Worthen's proposal to the investors specified that construction would cost approximately $7,500,000. After some

negotiation, Worthen narrowed the field of potential investors down to taxpayer and one other party. Worthen then proposed that the investor selected should supply an ownership "equity" of $500,000, which would bear "interest" at the rate of six percent per year. The remaining financing would be supplied to the investor by the prearranged mortgage from New York Life at the rate of six and three-quarters percent, payable in 25 years. Worthen would lease back the building from the investor under the conditions discussed below and would retain an option to repurchase at the end of the 11th, 15th, 20th, and 25th years at specific amounts, plus an assumption of the New York Life mortgage. If Worthen did not purchase the building during the 25-year primary term, it would have eight additional options to extend the lease, each for a five-year period (40 years total). Worthen would agree to execute a 75-year ground lease for the land under the building (ownership of which Worthen retained) to the investor, and to subject the adjacent parking facility (of which Worthen also retained ownership) and certain building furnishings and equipment to the New York Life mortgage. Worthen retained the rights to the investment tax credit and sales tax savings generated by the building project.

Taxpayer was selected by Worthen as the investor when it agreed to accept these terms and additionally agreed to reduce Worthen's building lease payments by $21,000 per year for the first five years. It later developed that New York Life would not accept assignment of a lease incorporating this rental reduction. Worthen and taxpayer then entered a lease at the rental originally proposed but by separate agreement provided for some additional benefits to accrue to Worthen in an independent transaction.[1] There-

[1] When New York Life refused to accept assignment of a lease with such a provision, as a substitute taxpayer agreed in August of 1969 to pay a higher than normal rate of interest on a $500,000 loan obtained from Worthen which taxpayer used to buy out the

after, taxpayer, Worthen, First National City Bank, and New York Life Insurance Company entered into various leases, assignments, notes, and agreements effective May 1968 and December 1969, whereby Worthen "sold" its building as it was constructed to taxpayer and Worthen then "leased back" the building from the taxpayer.[2]

The ultimate sale price of the Worthen building to taxpayer amounted to $7,640,000, of which New York Life furnished all but $500,000 through its mortgage. This mortgage was secured by a first deed of trust executed by taxpayer and Worthen which conveyed to New York Life title to the land, building, and a parking facility. As additional security, taxpayer assigned to New York Life its interest in the building lease and ground lease. By separate agreement with New York Life, Worthen consented to this assignment and agreed not to terminate the building lease as long as the mortgage remained outstanding.

Worthen's annual rent for the first 25 years of the building lease represents the exact amount necessary to fully

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shareholders of a Coca Cola Company. Taxpayer paid an interest rate three percent greater than its usual borrowing rate from Worthen. This one-year note has been renewed from time to time up to the date of trial without reduction of the principal.

[2] Worthen contracted for the building and supervised its construction. As construction progressed, Worthen transferred its interest in the building to taxpayer piecemeal so that the building never appeared as an asset on Worthen's books. The construction cost was paid by FNCB, the interim mortgagee, pursuant to an interim financing agreement between FNCB, Worthen, and taxpayer, in which Worthen conveyed title to the building, land, and banking facility to the lender, and taxpayer assigned its interest in the ground lease and building lease to FNCB as additional security for the loan. Worthen also guaranteed that the building and parking facility would be fully completed, free from liens, by December 1, 1969, and that if the construction loan had not been paid (through closing of the mortgage with New York Life) Worthen and taxpayer would enter into a new building lease on terms satisfactory to FNCB.

amortize the 25-year, $7,140,000 New York Life mortgage.[3] Should Worthen exercise its option to purchase during the primary term of 25 years, taxpayer would receive a net cash amount equal to its $500,000 "equity" investment plus six percent compounded interest. Should Worthen elect not to purchase the building and to continue paying rent for the potential additional 40-year life of the lease (eight extensions of five years), the rental payments provided will approach but not equal taxpayer's $500,000 investment compounded at a six percent rate.[4]

As we have already noted, Worthen retains an option to repurchase the building at the end of 11, 15, 20, and 25 years at the exact amount of taxpayer's investment of $500,000 in the transaction, compounded at six percent per

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[3] The rental owed by taxpayer to Worthen for the ground lease during the 25-year primary term amounts to the nominal sum of $50 per year. All parties are agreed that ground rents constitute a "wash" item since greater ground rents would call for an increased building rental to be paid by Worthen. However, after the first 25 years, the ground rents sharply increase to $100,000 per year starting in 1994, $150,000 in 1999, $200,000 per year in 2004, and $250,000 for the next 25 years to 2034. At the same time, the building lease rentals inexplicably become approximately halved to $30,000 per year. The ground lease is for a term of approximately 10 years longer than the 65-year building lease. During this last 10 years, the annual ground rent is set at $10,000. Should Worthen continue to occupy the building during this period, a new building lease and rental would have to be negotiated with taxpayer.

[4] As we have observed in note 3 *supra*, if the lease runs its full term, the taxpayer could negotiate a new lease for the building during the additional 10 years covered by the ground lease. Depending upon the rentals, the taxpayer could assure receipt of its original investment and the interest compounded thereon for the full 75-year period covered by the ground lease.

Taxpayer vehemently argues that Worthen will extend the lease to the full 65-year term. The Government argues that Worthen will exercise its purchase option.

annum, plus assumption of the unpaid balance of the New York Life mortgage. We observe in this connection that the first option period occurs after the first 11 years of the lease during which income tax savings to taxpayer from interest and depreciation will amount to about $1,500,000. Thereafter, taxpayer would reap no tax benefits from ownership. Increasing amounts of the rental received from Worthen and passed on to New York Life would apply to the principal of the mortgage rather than to interest, and hence would not be deductible. At the same time, allowable depreciation on the building would not equal the non-interest portion of the rent. The net result would be taxable income to taxpayer.

The various terms of the lease provide that essentially all costs, risks, and responsibilities rest with Worthen. For example, Worthen bears all repair and maintenance expense, all public utility charges, mechanics' liens, taxes and levies of every sort, and all insurance expenses, including property, liability, fire, war risk, and sprinkler and boiler damage. Worthen also must indemnify the lessor for any claim arising out of the operation of the building and repair any damage of destruction. By the terms of the lease, the rent is absolutely net to the taxpayer (and hence to New York Life) without allowance for any counterclaim, setoff, or defense by the lessee, and is to be paid without notice, demand, counterclaim, setoff, or defense lessee might otherwise assert.

Worthen's obligation to make payment of rent to taxpayer is not affected by any damage or destruction to the building. Interestingly, any condemnation or insurance proceeds resulting from total destruction apply in the following order: (1) to New York Life in an amount sufficient to fully prepay the mortage; (2) the balance to taxpayer up to the amount provided as the purchase price in the termination table (amortizing taxpayer's $500,000 investment at six percent); and (3) any excess to Worthen.

Worthen has the option to either replace the building or to purchase it in the event there is a partial condemnation or total destruction on or after December 1, 1980.[5]

On taxpayer's corporate income tax return for 1969, taxpayer reported the payments by Worthen under the building lease as rental income, and claimed deductions for depreciation on the Worthen building, interest paid on the interim and permanent mortgage loans, and other expenses it had borne with respect to the contruction of the building. Upon audit of the taxpayer's return for 1969, the Commissioner determined that for federal tax purposes the taxpayer was not the owner of the Worthen building, but that the real ownership in the building as a matter of economic substance was retained by Worthen. The Commissioner's notice of deficiency denied taxpayer's claimed deduction for depreciation, interest, and other expenses with respect to the construction of the buliding but eliminated the rental income reported by taxpayer for the lease of the building. Taxpayer thereafter paid the deficiency, filed a claim for refund, and upon its denial, brought the instant action. As previously noted, the district court granted relief.

Although the court made findings of fact, the essence of its holding is expressed in the court's unreported letter opinion of May 16, 1975, as follows:

> [T]he Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form

[5] The bank also reserved a right (by way of a separate letter agreement) to purchase the building at fair market value in the event of insolvency of the taxpayer or if the ownership of taxpayer company changes to others from that of Frank Lyon, his heirs, or his current working associates.

> of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sales-leaseback with option to repurchase.

The taxpayer emphasizes that the trial court's findings of intent resolve a question of fact and bind us on appeal unless "clearly erroneous". Taxpayer points to our prior ruling that

> where the true nature of payments made under a lease-purchase instrument is drawn into question in tax cases, it is necessary to ascertain what the parties intended. [*Western Contracting Corp.* v. *Commissioner*, 271 F.2d 694, 699 (8th Cir. 1959).]

Numerous other cases support the view that intent is an important consideration. *See American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974); *Breece Veneer & Panel Co.* v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956); *Benton* v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952). The Government responds that the ultimate question of ownership of property as it affects taxability rests upon a substantially undisputed record and must be reviewed as a question of law. *See American Nat. Bank of Austin* v. *United States*, 421 F.2d 442, 451 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); *Union Planters Nat. Bank of Memphis* v. *United States*, 426 F.2d 115 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970).

Both parties' positions are partially correct. It is our duty to ascertain the economic substance of transactions in order to determine their characterization for tax purposes. *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939). Since parties are generally free to dispose of property interests as they wish, the substance of a transaction usually derives from the parties' intent. Subject to certain policy considerations, the courts will respect the actual allocation of interests made by the parties even though it reduces or eliminates tax liability. *Helvering* v. *F. & R. Lazarus & Co.*, *supra*; *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

In major transactions, the intent of the parties is usually spelled out in written form. Where the documents embodying the transaction are clear and complete, the court is called upon to interpret the documents, and from their substance, to characterize the transaction for tax purposes as a matter of law. *See American Nat. Bank* v. *United States*, 421 F.2d 442 (5th Cir. 1969), *cert. denied*, 400 U.S. 819 (1970). However, where the documents are ambiguous or incomplete, the court must first ascertain the unexpressed subjective intent of the parties in order to properly interpret the agreement and thus disclose its substance. *See* and *compare Helvering* v. *F. & R. Lazarus & Co.*, *supra*; *Western Contracting Corp.* v. *Commissioner*, *supra*; *Benton* v. *Commissioner*, *supra*.

The court's determination of the parties' unexpressed subjective intent is a finding of fact. This inquiry may be assisted by the labels such as "lease" or "sale" which the parties have used in describing the transaction, but other factors are also significant and sometimes controlling. However ascertained, this subjective intent is of importance only to the extent that it affects the actual allocation of interests, not in spite of that allocation. We made this clear in *Western Contracting Corp.* v. *Commissioner*, *supra*, where we said the following:

> If the parties enter into a transaction which they honestly believe to be a lease but which in actuality

> has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it or how they treat it on their books. [*Id.* at 699; *quoting Oesterreich* v. *Commissioner*, 226 F.2d 798, 809 (9th Cir. 1955).]

In this case the allocation of interests between parties is spelled out in undisputed written documents. Characterization of the transaction for tax purposes requires us to "reason and interpret" these documents. *American Nat. Bank* v. *United States*, 421 F.2d 442, 451 (5th Cir. 1970). As the Fifth Circuit said, this "is the law obligation of the courts as distinguished from its fact finding duties". *Id.*, *quoting United States* v. *Winthrop*, 417 F.2d 905 (5th Cir. 1969).

We examine the issue of ownership by examining the respective rights held by the parties. In the common law sense, property rights can be analogized to a bundle of sticks. Each stick represents an interest in the underlying *res* which is the object of property. Certain commonly occuring bundles have been given conventional "labels" such as "lease" or "license". Frequently, the express agreement of the parties to a transaction will not specify the allocation of each stick. In such a case, the fact that the parties choose a particular label such as "lease" to describe the transaction may be a reliable guide to the allocation of sticks intended, although other indications of intent may modify or even supersede the labels employed. The determination of who got which bundle of sticks may require a determination of subjective intent and thus a preliminary finding of fact. However, except to the extent that subjective intent affects the allocation of the sticks, it is simply immaterial to the characterization of the transaction for tax purposes. Once the contents of each bundle is found, its tax characterization is strictly a question of law independently reviewable on appeal.

In this case the Government concedes that all parties intended to apply the label "sale-leaseback" to the transaction. However, the Government contends that this label has no real-world significance because every meaningful interest in the building was clearly possessed by Worthen by the agreement of the parties. In essence, the Government alleges that taxpayer totes an empty bundle and that the term "owner" for tax purposes cannot reasonably be attached to the empty wrapping taxpayer has retained.

Taxpayer responds that it cannot be assumed that Worthen will exercise its option to purchase and thereby reimburse taxpayer for its initial $500,000 investment plus accrued interest. Taxpayer further argues that if the purchase options are never exercised, it will eventually suffer the economic loss of depreciation and obsolescence of the building.

It is at this point that the ultimate issue is joined. The question for this court is whether, giving due deference to the underlying factual determinations of the district court, the taxpayer has demonstrated that it possesses sufficient genuine interests in the property to establish its legal right to be considered the owner for tax purposes. To resolve this question, we turn to the documents and undisputed testimony which establish the following allocation among the contracting parties of the benefits and burdens generated by the building.

1. Although mortgage monies and the half-million dollar contribution from the taxpayer covered the construction cost of the building, Worthen retained for itself the tax deduction for investment credit and sales taxes paid upon the materials which were purchased incident to the building's construction.

2. The lease agreements carefully circumscribed the usual right of an owner to obtain a profit from his investment by transferring his interest to a third party. Here,

Worthen insisted upon a letter agreement from Frank Lyon Company giving Worthen the right to purchase the building in the event of a transfer of ownership of the Frank Lyon Company to anyone other than Mr. Lyon, his immediate heirs, and his current working associates in the taxpayer-company. Although the letter agreement provided for a negotiated price, any such price would obviously be related to Worthen's long-term lease (which generates no cash flow) and options to purchase the building after 11, 15, 20, or 25 years for $500,000, plus six percent compounded interest on that amount, and the unpaid balance of the underlying building mortgage to New York Life.

3. Any appreciation in value of the building realized as the result of its destruction or condemnation accrues to Worthen and not taxpayer.

4. The parties geared the purchase-option price to the unpaid balance on the mortgage plus taxpayer's initial investment plus interest accrued thereon at the limited rate of six percent per annum compounded. The parties took no account of likely appreciation in the value of the building nor inflationary factors, the latter an almost constant factor in economics for the past 40 years, nor otherwise provided for purchase at a future appraised valuation of the building. The rental payments over the first 25 years of the lease reduce the purchase price dollar for dollar. By contrast, the parties apparently recognized the likely appreciation in land values by almost doubling the ground rents upon satisfaction of the mortgage.

5. The final option price at the end of the initial 25-year term on November 30, 1955, in the sum of $2,145,935, reflects taxpayer's initial investment plus compounded interest thereon over these years. At that time the present value of the future net rentals for the next 40 years, discounted at six percent, would approximate the taxpayer's original half-million dollar investment plus the compounded interest accrued to that date. Although this amount does

not fully amortize taxpayer's investment at six percent interest, the taxpayer is left with an additional ground lease for 10 years at only $10,000 per year with the right to negotiate with the bank or a new tenant for additional lease payments for the use of the building for the further period of 10 years. Thus, the taxpayer is given an opportunity to recoup his full investment at six percent interest prior to expiration of the ground lease.

6. The bank retained ultimate control over the disposition of the building through its various options for 65 years and its ownership thereafter of the land upon which the building rested.[6]

7. Finally, during the initial 25 years, the bank retained exclusive power to dispose of the building through its option privileges. During this period the taxpayer merely serves as a conduit for the lease payments to be transmitted to the mortgagee to pay the mortgage indebtedness. All responsibilities incident to the operation and ownership of the building otherwise rest with the bank. The only economic advantages inuring to taxpayer during this period are tax

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[6] The Government contends that under Arkansas law, Worthen will achieve absolute ownership of the building at the expiration of the ground lease. *Williams* v. *Kirby School Dist. No. 32*, 181 S.W.2d 488, 490 (Ark. 1944); *Wilson* v. *Davis*, 153 S.W.2d 171 (Ark. 1941). Taxpayer cites an 1878 case, *Sterman* v. *Cravens*, 33 Ark. 376 (1878), for the proposition that title to a building does not pass to the owner of the land upon the expiration of the lease unless the lease so provides. Worthen argues that if the parties cannot agree upon a subsequent lease or repurchase of the property between themselves, an Arkansas court of equity will order the sale of the land and building together and divide the proceeds in proportion to the respective value of the land and building. We need not resolve this issue except to note that the retention of the land reserved to Worthen substantial control over the ultimate disposition of the building should the bank forego its option privileges. Taxpayer's dubious claim to some form of equitable adjustment 75 years in the future does not substantially alter this conclusion.

shelter benefits worth one and one-half million dollars in tax savings to the taxpayer during the first 11 years (if it should be considered owner), plus a nominal return on its investment of six percent compounded annually. The contract provides for no return related to ownership risk.

We do not doubt that the Worthen bank drove a hard bargain. It suffered no significant economic detriment by allegedly not owning the building since it asserted the right to deduct lease payments from current income. Nor did the terms of the lease deprive it of any significant benefit of ownership. However, the lease did satisfy the technical requirements of the banking regulations. By contrast, the taxpayer seeks to be considered as the owner for the sole purpose of reaping a benefit from the tax laws of the United States which allow an owner of property to deduct both depreciation of an asset and interest payments upon the purchase mortgage.

The overall nature of this transaction is closely akin to that in *Helvering* v. *F. & R. Lazarus & Co., supra.* There the taxpayer was the seller-lessee, occupying essentially the same position as Worthen in the present case. The taxpayer had assigned title to two properties and a 99-year lease to a third to a bank and at the same time had leased the properties back for 99 years with an option to renew the lease and to purchase the properties. The Supreme Court affirmed the judgmment of the tax court which found that the taxpayer was the real owner of the properties. The Court characterized the bank's interest as an owner-lessor as essentially that of a mortgagee. It held that "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Id.* at 255. Nothing in the Court's opinion places any emphasis on the parties' desired characterization of the transaction for tax purposes.

The Government also points to the tax treatment afforded the taxpayers in *Commissioner* v. *H. F. Neighbors R. Co.*, 81 F.2d 173 (6th Cir. 1936), and *Frito-Lay, Inc.* v. *United States*, 209 F. Supp. 886 (N.D. Ga. 1962). Taxpayer here attempts to distinguish those cases factually and takes comfort in their language which places some emphasis upon the parties' intent. However, the intent found by the courts in those cases accorded with and contributed to the economic substance of the transactions. For example, in *Frito-Lay*, the court expressly stated that the intent of the parties was a "guide" to the true nature of the transaction, 209 F. Supp. at 891, not a component thereof.

In this case, as we have already held, the asserted "intent" to effect a sale-leaseback for tax purposes is not a guide to the economic substance of the transaction, but instead appears to be wholly unrelated to the actual allocation of interests. Taxpayer's reliance upon *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974), is misplaced. The arrangement there was not nearly so thin and transparent as the present transaction.

In sum, the benefits, risks, and burdens which taxpayer has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. Taxpayer's claim to a depreciation allowance as owner of the Worthen building must be disallowed.

The interest deduction here also turns upon the ownership of the building. The record is clear that the real security for the mortgage is the building and the party with the real interest in maintaining the mortgage payments is Worthen. In effect, we sustain the Government's position that taxpayer served as a mere conduit for the mortgage payments made by Worthen to New York Life. The Commissioner properly did not charge taxpayer with rental income in the receipt and transmission of these funds.

In closing, we note what our opinion does not do. First, what we have said relates only to the tax status of the Frank Lyon Company. Worthen is not a party to this appeal. Our opinion in no way affects Worthen's relationship to the Worthen building, as recognized by federal and state banking regulations.

Second, our opinion should not be read as a general condemnation of sale-leaseback arrangements. They are an accepted and useful means of controlling business property. As taxpayer argues, many of the features of the lease in this case have been held not to terminate tax ownership when viewed independently. The vice of the present lease is that all of these features have been employed in the same transaction with the cumulative effect of depriving the taxpayer of any significant ownership interest.

Accordingly, we reverse the judgment of the district court and remand this case for the entry of judgment against the taxpayer consistent with this opinion.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1975

No. 75-1615

FRANK LYON COMPANY, *Appellee*,

v.

THE UNITED STATES OF AMERICA, *Appellant*.

(Filed May 26, 1976)

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF ARKANSAS

Judgment

This CAUSE came on to be heard on the record from the United States District Court for the Eastern District of Arkansas and was argued by counsel.

On CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court, that the judgment of the said District Court, in this cause, be, and the same is hereby reversed.

A true copy.

ATTEST:

/s/ ROBERT C. TUCKER

Clerk, U. S. Court of Appeals, 8th Circuit.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 75-1615

FRANK LYON COMPANY, *Appellee*,

v.

UNITED STATES OF AMERICA, *Appellant*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF ARKANSAS.

Filed: August 6, 1976

Before BRIGHT and HENLEY, *Circuit Judges*, and REGAN, *District Judge*.*

Order

Appellant Frank Lyon Company has filed a petition for rehearing with a suggestion for rehearing *en banc*. The petition requests this court to determine the tax status of appellant's $500,000 investment in the Worthen building and to resolve the issue of the deductibility of interim interest and other expenses incurred by taxpayer.

While those issues were encompassed in the litigation, the precise matters referred to in the petition were neither the subjects of specific rulings by the district court nor were they briefed or argued in this court. Thus, they were not addressed in our opinion. We intend that those issues not disposed of by our opinion be resolved by the district court on remand, upon application of the parties should they fail to reach agreement. To clarify our intent, we

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* JOHN K. REGAN, *District Judge, Eastern District of Missouri*, sitting by designation.

direct that the final paragraph of our opinion be modified as follows:

> Accordingly, we reverse the judgment of the district court and remand this case for the entry of an appropriate judgment not inconsistent with this opinion.

With the exception of this clarification, the petition of Frank Lyon Company is denied.

SUPREME COURT, U. S.
FILED
APR 25 1977
MICHAEL RODAK, JR., CLERK

APPENDIX

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Appellant*,

v.

UNITED STATES OF AMERICA, *Appellee*.

ON PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

VOLUME I

(Pages 1-312)

PETITION FOR WRIT OF CERTIORARI FILED NOVEMBER 3, 1976
CERTIORARI GRANTED FEBRUARY 22, 1977

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Appellants*

v.

UNITED STATES OF AMERICA, *Appellee*

Petition for Writ of Certiorari Filed November 3, 1976

Certiorari Granted February 22, 1977

INDEX

	Page
Complaint, filed September 27, 1973	6
Answers, filed November 26, 1973	8
Stipulation, filed September 16, 1974	9
Supplemental Stipulation, filed December 23, 1974	14
Transcript of Proceedings, November 26, 1974	17
Supplementary Findings of Fact and Conclusions of Law, filed June 11, 1975	299
Proposed Findings of Fact and Conclusions of Law	301
Judgment, filed June 11, 1975	311
Notice of Appeal, filed August 11, 1975	312

Page

Plaintiffs' Exhibit 1: Letter dated August 26, 1967 from Edward M. Penick, President of Worthen Bank & Trust Company to O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis.. 313

Plaintiffs' Exhibit 2: Letter dated September 1, 1967 from Edward M. Penick to O. O. Wyrick 322

Plaintiffs' Exhibit 3: Letter dated September 12, 1967 from Edward M. Penick to O. O. Wyrick 324

Plaintiffs' Exhibit 4: Letter dated September 13, 1967 from O. O. Wyrick to Edward M. Penick 326

Plaintiffs' Exhibit 5: Letter dated September 1, 1967 from Edward M. Penick to H. C. Adams, Commissioner of State Bank Department 328

Plaintiffs' Exhibit 6: Letter dated September 5, 1967 from H. C. Adams to Edward M. Penick 336

Plaintiffs' Exhibit 7: Letter dated September 12, 1967 from Edward M. Penick to H. C. Adams 338

Plaintiffs' Exhibit 8: Letter dated September 13, 1967 from H. C. Adams to Edward M. Penick 339

Plaintiffs' Exhibit 9: Sale and Leaseback proposal dated September 28, 1967 to Goldman, Sachs & Co. 340

Plaintiffs' Exhibit 10: Revised Sale and Leaseback proposal dated October 27, 1967 of Stephens, Inc. 344

Plaintiffs' Exhibit 11: Letter dated October 30, 1967 from Frank Lyon to Worthen 346

Plaintiffs' Exhibit 12: Comparison of financing plans of Frank Lyon, Stephens, Inc. and Goldman, Sachs & Co. 348

Plaintiffs' Exhibit 13: Specification for Sale-Leaseback of Worthen Bank Building dated October 31, 1967 349

Plaintiffs' Exhibit 14: Letter dated November 1, 1967 from Frank Lyon to Worthen containing Lyon's proposal number 2 352

Plaintiffs' Exhibit 15: Comparison of financing plans dated November 2, 1967 355

Page

Plaintiffs' Exhibit 16: Letter dated Noevmber 30, 1967 from Alan W. Peters, Vice President of First National City Bank to Edward M. Penick 356

Plaintiffs' Exhibit 17: Letter dated December 18, 1967 from Richard W. Baker, Jr., Vice President of New York Life Insurance Company to Frank Lyon Company 358

Plaintiffs' Exhibit 18: Ground Lease dated May 1, 1968 between Worthen Bank & Trust Company, as Lessor, and Frank Lyon Company, as Lessee.... 366

Plaintiffs' Exhibit 19: Building Lease dated May 1, 1968 between Frank Lyon Company, as Lessor, and Worthen Bank & Trust Company, as Lessee. 376

Plaintiffs' Exhibit 20: Note Purchase Agreement dated May 1, 1968 between Frank Lyon Company and New York Life Insurance Company 443

Plaintiffs' Exhibit 21: Building Loan Agreement dated May 14, 1968 between Frank Lyon Company and First National City Bank 462

Plaintiffs' Exhibit 22: Building Loan Mortgage Note for $7,000,000 dated May 14, 1968 from Frank Lyon Company to First National City Bank 488

Plaintiffs' Exhibit 23: Building Loan Mortgage dated May 14, 1968 from Frank Lyon Company and Worthen Bank & Trust Company to First National City Bank 490

Plaintiffs' Exhibit 24: Assignment dated May 14, 1968 from Frank Lyon Company to First National City Bank 503

Plaintiffs' Exhibit 25: Sales Agreement dated May 19, 1968 between Frank Lyon Company, as purchaser, and Worthen Bank & Trust Company, as seller .. 508

Plaintiffs' Exhibit 26: Secured Note dated December 1, 1969 for $7,140,000 from Frank Lyon Company to New York Life Insurance Company 523

Page

Plaintiffs' Exhibit 27: First Deed of Trust dated December 1, 1969 from Frank Lyon Company and Worthen Bank & Trust Company to Darrell D. Dover and New York Life Insurance Company... 527

Plaintiffs' Exhibit 28: Assignment dated December 1, 1969 from Frank Lyon Company to New York Life Insurance Company 571

Plaintiffs' Exhibit 29: Consent and Agreement dated December 1, 1969 of Worthen Bank & Trust Company to New York Life Insurance Company 575

Plaintiffs' Exhibit 32: Specimen bank statement of Frank Lyon's account at First National City Bank with specimen checks and credit ticket attached.. 584

Plaintiffs' Exhibit 33: Comparative consolidated balance sheets of Frank Lyon Company and subsidiaries as of December 31, 1969 and 1968 587

Plaintiffs' Exhibit 34: Comparative consolidated statement of income years ended December 31, 1969 and 1968 of Frank Lyon Company and subsidiaries 589

Plaintiffs' Exhibit 35: Guaranty dated May 14, 1968 from Edward M. Penick, President of Worthen Bank & Trust Company to First National City Bank of New York 591

Plaintiffs' Exhibit 36: Computation of tax loss on Worthen Building of Frank Lyon Company for years 1969 through 1993; years 2007 through 2019 and years 2033 through 2044 595

Plaintiffs' Exhibit 37: Letter dated August 22, 1967 from O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis to Edward M. Penick, President of Worthen Bank and Trust Company of Little Rock, Arkansas 597

Plaintiffs' Exhibit 38: Summary of Conservation with Mr. O. O. Wyrick dated September 6, 1967 599

Plaintiffs' Exhibit 39: Letter dated September 20, 1967 from Mr. Theodore M. Siouris, A General Partner to E. M. Penick, President of Worthen Bank & Trust Company in reference to Sale-Leaseback Financing of New Bank Headquarters 601

Page

Plaintiffs' Exhibit 40: Letter dated April 16, 1968 from Edward Penick, President of Worthen Bank and Trust Company to Mr. H. C. Adams, State Bank Commissioner, Little Rock, Arkansas 609

Plaintiffs' Exhibit 41: Letter dated April 16, 1968 from Edward Penick, President of Worthen Bank and Trust Company to Mr. O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis.. 613

Plaintiffs' Exhibit 42: Letter dated April 19, 1968 from O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis to Mr. Edward M. Penick, President, Worthen Bank and Trust Company... 618

Plaintiffs' Exhibit 43: Letter dated April 22, 1968 from James Penick, Jr., Executive Vice President of Worthen Bank and Trust Company to Mr. O. O. Wyrick, Vice President, Federal Reserve Bank of St. Louis 620

Plaintiffs' Exhibit 44: Letter dated April 23, 1968 from O. O. Wyrick, Vice President, Federal Reserve Bank of St. Louis to Mr. James Penick, Jr., Executive Vice President, Worthen Bank & Trust Company 622

Plaintiffs' Exhibit 45: Comparison of annual rent with total of depreciation and interest for first 10 years of Worthen Bank Building 623

Plaintiffs' Exhibit 46: Worthen Bank & Trust Co. Rent Schedule on Worthen Building 1944 624

Plaintiffs' Exhibit 47: Safeway Lease 625

Plaintiffs' Exhibit 48: Inter-office communication dated May 13, 1969 from B. H. Dean, Jr. to James A. Rowland for Mr. W. H. Dodge regarding Safeway Lease 641

Plaintiffs' Exhibit 49: Letter dated July 28, 1971 from James B. Bolen, Jr. to T. H. Mayer and Nicholas M. Mayer enclosing Safeway Lease 663

Plaintiffs' Exhibit 50: Letter dated April 12, 1968 from Frank Lyon Company to Ed Penick, President, Worthen Bank and Trust Company 686

Page

Plaintiffs' Exhibit 51: Letter dated April 26, 1974 from Rudy Landry, Investment Officer of Cabot, Cabot & Forbes Equity Trust to Mr. Frank Lyon, Chairman of the Board, Frank Lyon Company 687

Plaintiffs' Exhibit 52: Explanation of Items of Frank Lyon Company 689

Defendants' Exhibit 1: Equity interest in land and buildings of Worthen Bank & Trust Co. 691

Defendants' Exhibit 2: Cash Flow, Frank Lyon Co.-Worthen Building 692

Defendants' Exhibit 3: Loss from Rental Operation, Frank Lyon Co.-Worthen Building 693

Defendants' Exhibit 4: Gain on Sale 1980 if 1980 Option is Exercised, Frank Lyon Co.-Worthen Building 604

Defendants' Exhibit 5: Tax Consequences vs. Economic Gain if 1980 Option is Exercised, Frank Lyon Co.-Worthen Building 695

Defendants' Exhibit 6: Tax Benefit—if Option Exercised November 30, 1980, Taking 1969 Tax Reform Act into Account, Frank Lyon Co.-Worthen Building 696

Defendants' Exhibit 7: Schedule of Direct Reduction Loan, Frank Lyon Company, Loan from New York Life (Schedule December 16, 1969) 697

Defendants' Exhibit 11: Letter dated November 28, 1969 from Frank T. McGehee, Assistant Vice President of Worthen Bank and Trust Company to New York Life Insurance Company 701

Defendants' Exhibit 12: Letter dated November 25, 1969 from Members American Institute of Certified Public Accountants of Gotham, Wyman & Howland to New York Life Insurance Company.. 705

Defendants' Exhibit 13: Letter dated September 2, 1966 from Richard F. Gates, Vice President to Mr. Harry E. Meek, Attorney, Little Rock 707

Page

Defendants' Exhibit 14: Letter dated October 13, 1966 with enclosures from Harry E. Meek, Attorney to Worthen Bank & Trust Company 708

Defendants' Exhibit 15: Letter dated September 8, 1967 from C. J. Giroir, Jr., Attorney to Worthen Bank and Trust Company 734

Defendants' Exhibit 16: Inter-office communication dated August 11, 1967 from Richard F. Gates to Edward M. Penick regarding financing of bank building (pp. 1 and 2, and 8-10) 742

FRANK LYON COMPANY

v.

THE UNITED STATES OF AMERICA

Date	Filings—Proceedings
9-27-73	Complaint filed. Summons issued and handed marshal for service.
10-9-73	Mar. det. on service on summons, by serving Jane Thompson, Secretary, on 10-1-73, and by certified letter to the Attorney General's Office, 9-27-73.
11-26-73	Answer filed. C/S.
8-13-74	Order setting pre-trial conference on Wed., Sept. 18, 1974, 11:00 a.m.
9-16-74	Stipulation filed by both parties.
9-20-74	Pre-Trial Order by J. Eisele ordering this case set for trial to the Court at 9:30 a.m. Tuesday, November 26, 1974; Deft. USA filed a demand for jury trial; it now desires to waive trial by jury; the case is therefore transferred to the non-jury docket; Pltf. has filed a pretrial brief with the Court. Deft. should provide the Court with citations of authority upon which it is relying; All discovery must be completed not later than November 8, 1974; No discovery will be permitted thereafter except to prevent manifest injustice; The Court will read the stipulation and all exhibits before trial, with reference to deft's exhibits there is no agreement that they are accurate or that they would represent the tax advantage to the Pltf. if his position were adopted, however, deft. will not be required to present the testimony of an agent who prepared them.
10-22-74	Deposition of Edward M. Penick filed by Court Reporter, taken Tuesday, September 17, 1974.
10-24-74	Deposition of Frank Lyon taken Sept. 12, 1974, Little Rock.

10-24-74—Deposition of E. Ralph Cotham taken 9-12-74, Little Rock.

11-15-74—Deposition of C. V. Barnes taken 11-4-74, Little Rock.

11-26-74—Trial to Court before Judge Eisele, 9:32 a.m.-6:00 p.m. continued.

11-27-74—Trial resumed 9:00 a.m.-5:07 p.m. After completion of testimony, Court stated some findings from bench: Frank Lyon is owner of building; it is highly improbable that Worthen will exercise option at end of 11th year or any other option period; there is no loan here, even if finally should determine Worthen owns the building. Simultaneous briefs due December 20; each party may respond by January 7, 1975.

12-3-74—Marshal's Return of Service on Frank Lyon, personally 11-26-74.

12-6-74—Marshal's Return of Service on Edward M. Penick, personally 11-22-74.

12-20-74—Deft's. Supplemental Memorandum of Fact and Law.

12-23-74—Supplemental Stipulation by parties.

1-7-75—Reply Brief—Deft.

5-21-75—Memorandum Letter Opinion, J. Eisele.

5-27-75—Excerpted Testimony filed by Reporter Fant (fr 11-27-74).

5-27-75—Excerpted Remarks filed by Reporter Fant (fr 11-27-74)

6-3-75—Original transcript of remarks made by the Court at close of trial led by Scott P. Crampton, Asst. Atty. Gen'l.

6-11-75—Supplementary Findings of Fact and Conclusions of Law filed by Judge Eisele.

6-11-75—Judgment pursuant to findings of fact and conclusions of law filed by Judge Eisele, entering judgment in favor of plaintiff in the following amounts with interest from dates indicated:

$32,624.32 with interest thereon from March 15, 1969;

$231,871.26 with interest thereon from March 15, 1970;

$43,790.84 with interest thereon from April 19, 1973.

8-5-75—Orig. & 1 copy of Vols. I & II of transcript of trial filed by Reporter Fant.

8-11-75—Notice of Appeal for judgment of 6-11-75 by U.S. Dist. Court to U.S. Court of Appeals for the 8th Circuit: Certified copy of N/A & 2 cert. copies of docket entries to 8th Cir.; copies to U.S. Atty., appellant—J. Gaston Williamson, atty. for appellee—& to Carolyn Fant, Court Reporter.

GENERAL DOCKET

United States Court of Appeals
For the Eighth Circuit

Appeal from Eastern District of Arkansas

Case No. 75-1615

Frank Lyon Company, Appellee,
vs.
The United States of America, Appellant.

Date 1975	Filings—Proceedings	Filed
Aug. 13	Docketed appeal	
Aug. 13	Cert. copies Notice of Appeal, Docket Entries of D.Ct.	(1)

Aug. 18—Appearance appellee (2)

Aug. 19—Appearance appellant (3)

Aug. 25—Appearance appellant (4)

Sept. 19—Motion appellant for extension of time to file appendix and brief (5)

Sept. 19—Order: Appellant may have thru October 22 to serve and file appendix and opening brief (6)

Oct. 24—Appendix (vol. 1 & 2) w/service (7)

Oct. 24—Brief appellant w/service (8)

Oct. 24—Four copies exhibit volume

Oct. 28—Appearance appellant (9)

Nov. 25—Order: Appellee may have thru December 4 to serve and file brief (10)

Dec. 3—Brief appellee (11)

Dec. 3—Affidavit of service w/brief appellee (12)

Dec. 8—Submitted to screening panel

Dec. 19—Mo applnt for ext to file reply brief (13)

Dec. 23—Order: Appellant granted to January 2 to serve and file reply brief (14)

1976

Jan. 5—Reply brief appellant w/ser (15)

Jan. 21—Transferred to February session

Feb. 13—Appearance for appellee (16)

Feb. 13—Argued and submitted to Judges Bright, Henley, Regan. Gary Allen, Dept. of Justice for appellant; C. J. Giroir, Jr. for appellee; concluded by Mr. Allen. Recorded

May 26—Opinion by Judge Bright (Published) (17)

May 26—Judgment: Judgment of district court is reversed and remanded to district court for proceedings consistent with opinion (18)

June 4—Appellee's bill of costs (19)

June 4—Appearance for appellee (20)

June 4—Mo appellee for ext to file pet for reh/reh en banc (21)

June 4—Order: Appellee may have thru June 18 to file petition for rehearing (22)

June 17—Petition of appellee for rehearing en banc and rehearing (23)

Aug. 6—Order: Petition of appellee for rehearing en banc is denied (24)

Aug. 6—Order: This court directs that our opinion be modified; petition for rehearing of Frank Lyon Co. is denied (Printed, Published) (25)

Aug. 16—Mandate issued

Aug. 19—Receipt for mandate (26)

Nov. 8—Notice of filing of petition for writ of certiorari in Supreme Court as Case No. 76-624 (as of 11/3/76) (27)

1977

Mar. 3—Order of Supreme Court in Case No. 76-624 granting certiorari (28)

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Complaint

(Filed September 27, 1973)

The plaintiff, Frank Lyon Company, for its cause of action against the defendant, United States of America, states:

1. Plaintiff is, and at all times mentioned in this complaint was, a corporation organized and existing under the laws of the State of Arkansas with its principal place of business in Little Rock, Pulaski County, Arkansas.

2. This is an action for the recovery of internal revenue taxes, with interest thereon, erroneously and illegally assessed and collected. Jurisdiction is conferred upon this Court by Title 28, United States Code, Sec. 1346(a)(1), as amended.

3. Plaintiff filed its income tax return for the calendar year 1969 with the Internal Revenue Service Center, in Austin, Texas, and paid the tax reported due thereon. Following an examination of said return, the Commissioner of Internal Revenue assessed an income tax deficiency against plaintiff for 1969 as follows:

Tax Deficiency	Interest	Total Assessment
$261,063.34	$48,339.63	$309,402.37

Plaintiff paid said deficiency assessment to the Internal Revenue Service Center, in Austin, Texas, on April 19, 1973.

4. Of the total deficiency assessment for 1969, $24,466.98, together with interest in the amount of $4,548.79, was attributable to adjustments not contested by the taxpayer. The remaining deficiency assessment was attributable to the Commissioner's erroneous determinations that plaintiff was not the owner of the Worthen Bank Building in Little Rock, Arkansas, and was not entitled to deduct certain expenses attributable to said building as set forth in plaintiff's claim for refund, a copy of which is attached hereto as Exhibit "A" and incorporated herein by reference.

5. On July 20, 1973, plaintiff filed with the Internal Revenue Service Center, in Austin, Texas, a claim for refund (Exhibit "A") of income tax for 1969 in the amount of $236,596.36, plus interest paid thereon in the amount of $43,790.84, no part of which has been repaid to plaintiff. As grounds for recovery, some of which are stated in the alternative, plaintiff incorporates herein by reference the averments contained in its claim for refund for 1969.

6. By certified letter dated August 22, 1973 from the Internal Revenue Service Center in Austin, Texas, plaintiff received statutory notice that its claim for refund for 1969 had been disallowed in full. A copy of said letter is attached hereto as Exhibit "B".

WHEREFORE, plaintiff prays for judgment against defendant for income taxes overpaid for 1969 in the amount of $236,596.36, plus interest assessed thereon in the amount of $43,790.84, for a total of $280,387.20, together with its costs and interest as provided by law, and for all other relief to which plaintiff is entitled.

/s/ J. GASTON WILLIAMSON
J. Gaston Williamson
720 West Third Street
Little Rock, Arkansas 72201
Attorney for Plaintiff

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Answer

[Filed November 26, 1973]

The defendant, United States of America, by its attorney, W. H. Dillahunty, United States Attorney for the Eastern District of Arkansas, for its answer to the complaint herein admits, denies, and alleges as follows:

1. Admits the allegations contained in paragraph 1.

2. Admits the allegations contained in paragraph 2, except denies that any tax or interest was erroneously and illegally assessed and collected.

3. Admits the allegations contained in paragraph 3, except alleges that the total deficiency assessment was $309,402.97, rather than the amount alleged in the complaint and further alleges that the Internal Revenue Service received payment of this amount on April 20, 1973, rather than the date alleged.

4. Is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 4, except denies that any determination of the Commissioner was erroneous and further denies each and every allegation contained in the claim for refund unless specifically admitted herein, except admits that a copy of the claim for refund was attached to the complaint as Exhibit A.

5. Admits the allegations contained in paragraph 5, except alleges that plaintiff's claim for refund was received on July 24, 1973, rather than the date alleged in the complaint and denies each and every allegation contained in the claim for refund unless specifically admitted herein.

6. Admits the allegations contained in paragraph 6.

Wherefore, defendant prays for judgment in its favor, allowing the defendant its costs, and for such other relief as this Court may deem just and proper.

W. H. Dillahunty
United States Attorney

By:
Assistant United States Attorney

Demand For Jury Ttial

Defendant demands a trial by jury of all issues of fact arising out of this action.

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Stipulation

[Filed September 16, 1974]

It is hereby stipulated by and between the parties hereto that for the purpose of this case the following facts may be taken as true, subject to the right of either party to object to the admission of such facts in evidence on the grounds of materiality or relevance; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. This is an action for the recovery of Internal Revenue taxes, with interest thereon. Jurisdiction is conferred upon this Court by Title 28, United States Code, Section 1346(a)(1) as amended.

2. The plaintiff filed its income tax return for the calendar year 1969 with the Internal Revenue Service Center, in Austin, Texas, and paid the tax reported due thereon. Following an examination of plaintiff's return, the Commissioner of Internal Revenue determined that plaintiff was "not the owner for tax purposes of any portion of the Worthen Building" and therefore disallowed the following items of income and expenses related to that building:

Item	Amount
Rental income from Worthen Bank	$(48,527.01)
Depreciation on building	51,618.79
Interest paid to First National City bank on interim financing	403,899.54
Legal expense	33,351.05
Title insurance	10,140.00
Audit expense	3,475.00
Telephone and travel	801.16
Interest expense to New York Life	40,162.50
Accrued interest income on investment	2,298.15
Total	$497,219.18

Based upon those adjustments, the Commissioner of Internal Revenue assessed against plaintiff an income tax deficiency of $236,596.36, together with interest in the amount of $43,790.84, making a total deficiency assessment of $280,387.20.

3. The amounts sued for in the complaint were timely assessed by the Commissioner of Internal Revenue, and payment of the deficiency assessments was made by the plaintiff on the dates disclosed in the claim for refund. Claim for refund was timely filed, and the claim for refund was denied by the Commissioner of Internal Revenue. The action filed by plaintiff for the recover of the amount set forth in its claim for refund was begun within the time permitted by Title 26, United States Code, Section 6532 (a)(1).

4. Attached hereto are copies of the following documents which may be introduced by plaintiff during the trial of this case in lieu of the original copies of said documents:

PX 1. Letter dated August 26, 1967 from Edward M. Penick, President of Worthen Bank & Trust Company, to O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis.

PX 2. Letter dated September 1, 1967 from Edward M. Penick to O. O. Wyrick.

PX 3. Letter dated September 12, 1967 from Edward M. Penick to O. O. Wyrick.

PX 4. Letter dated September 13, 1967 from O. O. Wyrick to Edward M. Penick.

PX 5. Letter dated September 1, 1967 from Edward M. Penick to H. C. Adams, Commissioner of State Bank Department.

PX 6. Letter dated September 5, 1967 from H. C. Adams to Edward M. Penick.

PX 7. Letter dated September 12, 1967 from Edward M. Penick to H. C. Adams.

PX 8. Letter dated September 13, 1967 from H.C. Adams to Edward M. Penick.

PX 9. Sale and Leaseback proposal dated September 28, 1967 of Goldman, Sachs & Co.

PX 10. Revised Sale and Leaseback proposal dated October 27, 1967 of Stephens, Inc.

PX 11. Letter dated October 30, 1967 from plaintiff to Worthen confirming verbal proposal of plaintiff.

PX 12. Comparison of financing plans of plaintiff, Stephens, Inc. and Goldman, Sachs & Co.

PX 13. Specification for Sale-Leaseback of Worthen Bank Building dated October 31, 1967.

PX 14. Letter dated November 1, 1967 from plaintiff to Worthen containing plaintiff's proposal number 2.

PX 15. Comparison of financing plans dated November 2, 1967.

PX 16. Letter dated November 30, 1967 from Alan W. Peters, Vice President of First National City Bank to Edward M. Penick.

PX 17. Letter dated December 18, 1967 from Richard W. Baker, Jr., Vice President of New York Life Insurance Company to Frank Lyon Company.

PX 18. Ground Lease dated May 1, 1968 between Worthen Bank & Trust Company, as Lessor, and Frank Lyon Company, as Lessee.

PX 19. Building Lease dated May 1, 1968 between Frank Lyon Company, as Lessor, and Worthen Bank & Trust Company, as Lessee.

PX 20. Note Purchase Agreement dated May 1, 1968 between Frank Lyon Company and New York Life Insurance Company.

PX 21. Building Loan Agreement dated May 14, 1968 between Frank Lyon Company and First National City Bank.

PX 22. Note for $7,000,000 dated May 14, 1968 from Frank Lyon Company to First National City Bank.

PX 23. Building Loan Mortgage dated May 14, 1968 from Frank Lyon Company and Worthen Bank & Trust Company to First National City Bank.

PX 24. Assignment dated May 14, 1968 from Frank Lyon Company to First National City Bank.

PX 25. Sales Agreement dated May 19, 1968 between Frank Lyon Company, as purchaser, and Worthen Bank Trust Company, as seller.

PX 26. Note dated December 1, 1969 for $7,140,000.00 from Frank Lyon Company to New York Life Insurance Company.

PX 27. First Deed of Trust dated December 1, 1969 from Frank Lyon Company and Worthen Bank Trust Company to New York Life Insurance Company.

PX 28. Assignment dated December 1, 1969 from Frank Lyon Company to New York Life Insurance Company.

PX 29. Consent and Agreement dated December 1, 1969 of Worthen Bank Trust Company to New York Life Insurance Company.

PX 30. Specimen letter dated September 11, 1969 from Worthen to plaintiff requesting partial payment toward purchase price of building.

PX 31. Specimen letter dated September 15, 1969 from plaintiff to First National City Bank requesting disbursement under interim loan.

PX 32. Specimen bank statement of plaintiff's account at First National City Bank with specimen and checks and credit ticket attached.

PX 33. Comparative consolidated balance sheets of Frank Lyon Company and subsidiaries as of December 31, 1968 and 1969.

PX 34. Comparative consolidated statement of income for calendar years 1968 and 1969.

5. Attached hereto are copies of the following documents which may be introduced by defendant during the trial of this case in lieu of the original copies of said documents:

DX 1. Schedule reflecting equity interest in land and buildings of Worthen Bank Trust Company 1969.

DX 2. Schedule reflecting cash flow to Frank Lyon Company on Worthen Bank Building lease.

DX 3. Schedule reflecting Frank Lyon Company loss from rental operation of Worthen Bank Building.

DX 4. Schedule reflecting gain on sale of Worthern Building by Frank Lyon Company if 1980 option is exercised.

DX 5. Schedule reflecting tax consequences versus economic gain of Frank Lyon Company from sale of Worthern Bank Building if 1980 option exercised.

6. Either party may introduce additional exhibits if copies thereof are furnished to opposing counsel and a list thereof furnished to the Court at least 15 days before the trial of this case.

/s/ J. G. WILLIAMSON
J. G. Williamson
720 West Third Street
Little Rock, Arkansas 72201
Attorney for Plaintiff
W. H. DILLAHUNTY
United States Attorney

By: /s/ EUGENE C. SAYRE
Eugene C. Sayre
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8E2 Federal Office Bldg.,
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[Exhibits contained in a separate Exhibit Volume]

IN THE UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

Supplemental Stipulation

[Filed December 23, 1974]

It is hereby stipulated by and between the parties hereto that for the purposes of this case the following facts may be taken as true:

1. Due to an oversight by the accountant who prepared plaintiff's income tax return for 1969, no portion of the following items of expense paid in 1969 and attributable to the Worthen Building were deducted on plaintiff's federal income tax for 1969:

Date Paid	Payee and Description	Amount
11-31-69	1st. Nat'l. City Bk., int. on interim loan	$49,583.33
12- 3-69	SW Bell Tel. Co., interim loan	1.60

12- 8-69	Beach Abstract Co., title ins. interim loan	3,405.50
12- 9-69	Parkin Prtg., printing Bldg. Loan Agreement	216.77
12-23-69	House, Holmes & Jewell, atty. fee NYL loan	2,830.45
12-23-69	Cotham, Wyman & Howland, fee re interim loan	1,750.00
12-31-69	Rose Law Firm, atty. fee NYL loan	4,000.00

2. The total interest paid by plaintiff on the interim loan from First National City Bank and the calendar year in which it was paid or accrued was as follows:

Paid or accrued in 1968	$ 40,411.90
Paid or accrued in 1969	413,070.97
Total	$453,483.87

3. The travel and telephone expenses paid by plaintiff attributable to the Worthen Building and deducted on plaintiff's 1969 return were paid or accrued in the following calendar years:

Paid or accrued in 1968	$ 792.80
Paid or accrued in 1969	226.73
	$1,019.53

4. The legal and accounting fees and title insurance expense attributable to the Worthen Building, the year such items were paid or accrued and the proper allocation of such items between the First National City Bank ("FNCB") interim loan, the New York Life Insurance Company ("NYL") permanent loan and the acquisition of the building (Sales Agreement) by plaintiff are as follows:

	1968		
	FNCB Loan	NYL Loan	Building
Shearman & Sterling, legal fees	$ 7,000.00		
House, Holmes & Jewell, legal fees		$ 8,548.34	

Rose Law Firm, legal fees	5,340.81	10,681.63	$1,780.27
Cotham, Wyman & Howland, acct. fees	1,475.00		
Little Rock Abstract Co., title ins.	5,092.50		
Beach Abstract Co., title ins.	4,927.50		
Total	$23,835.81	$19,229.97	$1,780.27

	1969 FNCB Loan	NYL Loan	Building
House, Holmes & Jewell, legal fees		$ 2,830.45	
Rose Law Firm, legal fees		4,000.00	
Cotham, Wyman & Howland, acct. fees	$ 2,000.00	1,750.00	
Little Rock Abstract Co., title ins.	120.00		
Beach Abstract Co., title ins.		3,405.50	
Total	$ 2,120.00	$11,985.95	—0—

/s/ J. G. WILLIAMSON
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Attorney for Plaintiff
W. H. DILLAHUNTY
United States Attorney
By: /s/ EUGENE C. SAYRE
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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF ARKANSAS

(Caption Omitted In Printing)

Transcript of Proceedings

(November 26, 1974)

[erroneously dated November 26, 1975]

* * *

[42]

* * *

Thereupon,

Ralph Cotham, Jr.

having been called as a witness by and on behalf of plaintiff, and having been first duly sworn, was examined and testified as follows:

The Court: Take the stand.

Mr. Giroir: Your Honor, before beginning examination, we do want to submit PX 36 as an exhibit. I have furnished Mr. Sayre a copy of it. It is a computation of the tax loss to Frank Lyon Company for the year 1969 through 2044 in respect [43] to the Northern Bank Building.

The Court: Now this is an exhibit that has not been received?

Mr. Giroir: That's correct.

The Court: Have you showed it to Mr. Sayre?

Mr. Sayre: Yes, Your Honor, I have just received it and at this time I have no objection to its introduction.

The Court: Very well.

Mr. Sayre: I believe it is what it purports to be, that being a computation of a 75 year—

The Court: It is received.

Mr. Sayre: Based upon the fact no options are exercised; is that correct?

Mr. Girori: That's correct.

The Court: Do you have an extra copy?

Mr. Giroir: Yes, I do.

The Court: All right.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 36 and was received in evidence.)

DIRECT EXAMINATION

By Mr. Giroir:

Q. Mr. Cotham, state your name. A. Ralph Cotham, Jr. [44] Q. What is your residence address A. 1600 North Jackson, Little Rock, Arkansas.

Q. What is your occupation? A. Currently I am employed as vice-president of finance for Frank Lyon Company.

Q. How long have you been employed by the Frank Lyon Company? A. Since 1966.

Q. What is your present office of Frank Lyon Company? A. Presently I am vice-president of finance.

Q. How long have you been vice-president of finance? A. Since the first of the year.

Q. What office did you hold prior to that time? A. Prior to that time I was secretary-treasurer.

Q. Did you hold the job of secretary-treasurer from 1966? A. No. In '66 I came as assistant secretary-treasurer and then became treasurer of the corporation and then became secretary-treasurer of the corporation, and I am still the secretary of the corporation but also vice-president of finance.

Q. You have been involved in the company's financial affairs since your first—— A. That's correct.

Q. What is your education? [45] A. I attended the Little Rock public schools, was graduated from Little Rock Central High School, enrolled at the College of Arts and Sciences at Vanderbilt University, was graduated there with a B.A. degree and enrolled in the school of law and received an L.L.B. degree. I was employed first by a public accounting firm. I took some undergraduate courses at UALR and took and sat for and passed the CPA exam, and I am also a certified public accountant.

Q. Are you a licensed attorney? A. Yes, sir, I am.

Q. What associations or societies are you a member of? A. I am a member of the American Bar Association, the Arkansas Bar Association, the American Institute of Certified Public Accountants, the Arkansas Society of Certified Public Accountants. And as you pointed out, I am also licensed to practice law before the Arkansas Supreme Court as well as the Eastern District of Arkansas federal court.

Q. Mr. Cotham, would you tell us what the business of Frank Lyon Company was in 1967? A. In 1967, Frank Lyon Company was a wholesale distributor of home furnishings, primarily RCA electronic products. This included TV sets, stereos, Whirlpool products, which included refrigerators, freezers, washers, air conditioners, and a little bit of furniture. The primary thing was [46] distributing RCA and Whirlpool products.

Q. How many officers did Frank Lyon Company have at that time? A. There were four branches. One is located in Springfield, Missouri; one in Fort Smith, Arkansas; and one in Shreveport, Louisiana; and then, of course, the home office is here in Little Rock.

Q. And was the company involved in basically the same business at all these offices? A. We were not involved in furniture in Springfield or in Fort Smith. We were not involved in selling RCA products in Shreveport.

Q. But each of them were home appliances? A. All of them were home appliances, wholesale distributor.

Q. Could you have opened additional offices in that business? A. No, sir, we could not.

Q. Why not? A. Our contracts with the factory specified primary areas of the responsibility, and we are required under our contract with both RCA and Whirlpool to have offices within our primary areas of marketing responsibility.

Q. Did you think you had saturated your market responsibility area? [47] A. Yes, although we were still striving to improve our market share a little bit. We do get market penetration figures which are industry-wide, which show the total number of TV sets that are sold as an example. We know what percentage are RCA and what percentage Zenith and what percentage Sylvania, and what percentage are Panasonic and Sony, et cetera.

Q. Is the Frank Lyon Company now involved in other active businesses—that is, other than the wholesale distributorship of furniture and appliances? A. Yes. In 1968 and 1969 the Frank Lyon Company purchased controlling interest of the Coca Cola Bottling Company of Arkansas and also the Twin City Bank.

Q. Did you say those were acquired in 1968? A. '69—'68 and '69. The bang was acquired in 1968. The Coca Cola Company was acquired in '69.

Q. Now, as—

The Court: Is that Coca Cola—

The Witness: Bottling Company of Arkansas.

By Mr. Giroir:

Q. You say "the bank." Would you describe the bank in which you have an investment? A. This is the Twin City Bank of North Little Rock, Arkansas. It is currently constructing an eight-story building across the river. At the time we purchased it, it had total assets of around $15 million. Under the excellent leadership [48] of Mr. Terry Renaud, who is president and chairman of the board, it now has total assets of around $85 million.

The Court: You mean since 1968?

The Witness: Yes, sir.

By Mr. Giroir:

Q. The Coca Cola Company, would you describe its operation? A Coca Cola Bottling Company is a bottler of soft drink beverages. It buys syrup from the Coca Cola Company, as well as from the Dr. Pepper Company, mixes it under the strict guidelines so the trademark is not infringed, puts it in bottles or cans and sells it both in vending machines such as the one on the floor here, as well as the supermarkets for the ultimate resale to consumers.

Q. What is its trade area? A. Its trade area is approximately one-third of the State of Arkansas. We do not have Pine Bluff. We have Little Rock, Searcy, go all the way up to Harrison, Arkansas; Little Rock and north, excluding Fort Smith and West Memphis and Jonesboro.

Q. To disgress for a minute, when you made these acquisitions, did you buy stock in each instance? A. Yes, we did.

The Court: Are they now wholly-owned subsidiaries or partially?

[49] The Witness: Your Honor, the Coca Cola Bottling Company of Arkansas is a wholly-owned subsidiary. Twin City Bank, 92 percent of the stock is owned. The other shares are owned by either officers or directors of Twin City Bank.

By Mr. Giroir:

Q. Basically qualifying shares? A. With the exception of Mr. T. E. Renaud's share ownership which is five percent of the outstanding.

Q. Your purchase of the stock of Twin City Bank, was that paid for in cash? A. Yes, it was. However, we borrowed funds from Republic National Bank.

Q. Your purchase of the stock of Coca Cola Bottling Company, was that paid for in cash? A. No, Mr. Giroir, it was not. It was the desire of the selling stockholders to maximize really their tax benefit and they required a down payment of 29 percent in cash and wanted corporate notes for a four-year period in annual payments of principal. So we paid 29 percent of it down.

Q. Roughly, how much did that 29 percent amount to? A. It was over a million dollars.

Q. And then the balance? A. And then the balance was paid for in four annual equal installments on August the 21st of each year, and that would be '70, '71, '72 and '73. [50] Q. When, as an officer of Frank Lyon Company, did you first learn of the company's interest in purchasing the Worthen Building? A. Mr. Lyons, the chairman of the board, asked me to stay a few minutes after our October 1967 board meeting and asked me what I thought of perhaps the company's owning the Worthen Bank Building. Of course, I hadn't given it much thought at all. I told him I would be glad to look into it and he urged me to do so as fast as possible and asked me to get back with him the first thing the next morning and report to him on my preliminary findings.

Q. At that point, what information did you have in respect to the investment? A. Only what he had given me, which was that the building was going to cost around $7.5 million, that we should not be too concerned with the permanent financing because Worthen Bank had already made some inquiries of some potential mortgage holders; an investor acceptable to both Worthen and, in this instance, New York Life would be able to take advantage of these initial contacts.

Q. What was your report to Mr. Lyon the next morning? A. It was an oral report. I correlated it to the objective really that the board of directors had adopted and said that I thought the possibility was worth exploring, but to really give or to give a thorough analysis that we needed [51] more information.

Q. Did you get more information? A. Yes, I did.

Q. How did you get it? A. I think at that time Mr. Lyon was going to attend a meeting at Worthen Bank and I believe spoke with Mr. Penick about the possibility of Frank Lyon Companies becoming a candidate for ownership of the building, and after their discussions then Mr. Lyon asked me to call Mr. Dick Gates who was at the time—was vice-president of Worthen Bank and was responsible for coordinating and analyzing from Worthen's point of view the various proposals they had received from other potential investors. I did so and he gave me a little more detailed information.

Q. Did you consult with any advisors in connection with your ultimate report to Mr. Lyon? A. No, sir, I did not.

Q. What was your ultimate report to Mr. Lyon? A. That I thought we ought to make a bid to own the building.

Q. At that point, was your recommendation at all predicated upon the existence of permanent financing by New York Life? A. Yes, it was, and I was really surprised in talking with Mr. Dick Gates how much they were really selling an [52] economic unit or offering to investors the economic unit, and they had made several contacts and gone into a great deal of detail with the financing officers of New York Life Insurance Company concerning New York Life Insurance Company placing a mortgage on the entire building.

Q. How did the existence of this at least tentative commitment for permanent financing affect your problem or your undertaking to make a proposal on the building? A. Quite frankly, it made it a whole lot easier. When you are going to make a seven or eight million dollar investment, the first question that always comes into my mind is where are you going to get the money. In this instance, Worthen Bank had already had contact to in part satisfy this question or answer this question.

Q. How did it affect what rental you were willing to receive? A. Well, in real estate investments at this time the

minimum requirement we would have is sufficient rental income to amortize the debt service. When you know what the annual debt service is going to be that gives a floor, which in our particular instance we were somewhat reluctant to go much below that.

Q. Did the Frank Lyon Company make a proposal to Worthen Bank? A. Yes, they did, Mr. Giroir.

[53] Q. Do you have a copy of that proposal? A. I don't have it with me. It's in the stipulation of the facts.

Q. I believe that's stipulation number 11 or PX No. 11. A. PX 11.

Q. Would you read that proposal? A. This is a letter dated October 30, 1967 from Mr. Frank Lyon, Chairman of the board of Frank Lyon Company, to Mr. Ed Penick, president of Worthen Bank and Trust Company.

"Dear Ed: In our prior conversations I have stated a definite interest in Frank Lyon Company's owning the new Worthen Building. We propose to purchase the building from you for $7.5 million under a sale and leaseback arrangement and to borrow the money from New York Life Insurance Company on a note secured by a first mortgage on the building, a conditional assignment of your lease and the general credit of Frank Lyon Company.

The lease will require you to pay all expenses necessary to operate and maintain the building including all repairs, taxes and required insurance."

Q. Do you want to continue? A. "The annual rental payment will be $50,000.00 less than the amount of mortgage payments for the first ten years, will be equal to our mortgage payments for the duration of the [54] original mortgage and will be $600,000.00 per year for the remainder of the lease.

Worthen will have the option to purchase the building after 15 years for $1.7 million cash, plus the assumption of the original mortgage. Worthen will also have options to

repurchase the building after 20, 25, 30, 35 and 40 years on a basis acceptable to Worthen Bank.

This letter merely outlines our proposal. We are flexible and want to negotiate an arrangement which is fair and equitable to both parties. Sincerely, Frank Lyon Company, Frank Lyon, chairman of the board."

Q. Did you consider this to be a definitive offer to purchase the building? A. It certainly contained most of the essential terms that we thought Worthen was looking to. Honestly, we were trying to get our foot in the door. It was quite obvious from what Mr. Dick Gates told me that other investors had made firm proposals and were under consideration, and that Worthen Bank was going to make a decision immediately. So we were, as I said, really trying to get our feet in the door.

Q. What was the response from Worthen Bank to your proposal? A. They came back and said they were—liked the terms, but there were other investors that had also submitted very attractive bids to them and they suggested that perhaps [55] Frank Lyon Company and Stephens, Inc. form a partnership to own the building jointly.

Q. What was your response to that? A. We didn't think much of that idea.

Q. Why not? A. Well, several reasons. We did not want to split any of the benefits of ownership with a third party. We knew there was going to be some hard negotiations between ourselves and Worthen Bank to kind of put the meat on this skeleton. We thought we could do it better with ourselves and Worthen Bank instead of trying to involve a third party in it. We had no prior experience of any business dealings or partnership arrangements with Stephens and this would be kind of new waters for us to tread into.

Q. So did I understand that you declined to enter into a joint venture? A. Very violently, yes. We declined.

Q. What was Worthen response to your declining to joint venture the ownership? A. Either one or two days thereafter, they contacted us again and said that rather than the

joint ownership they would like to submit to the narrow field of bidders on the building specifications for a sale and leaseback. This was a two-page typed document. They gave it to us and asked for an immediate response as to whether or not these terms would be [56] acceptable or if we wanted to modify them in any way to be sure to specify what that would be.

Q. Is that specification the document that appears as PX No. 13? A. Yes, it is, Mr. Giroir.

Q. Without going into great detail, in what material respects did the specifications deviate from your original proposal? A. Well, the big deviation came in the option price after 15 years. We had proposed to sell them the building for $1.7 million plus assuming the unpaid balance of the mortgage. In paragraph five they trimmed that back substantially.

We had also proposed rentals.

Q. When you say "substantially"—— A. They trimmed it back to only a million dollars including—to a million dollars.

Q. That was a $700,000 reduction. A. They almost cut it in half.

Q. In what other respects did the specification deviate from your proposal? A. We had proposed net rental income to Frank Lyon Company of $600,000.00. They trimmed this by $400,000.00 during the first initial five year term, made it only $200,000.00 and then cut it $50,000.00 for each five succeeding years.

[57] Are you speaking now of the renewal period following the 25 years? A. That's correct.

Q. So they reduced your net rental income during the renewal period by approximately two-thirds? A. Yes. From $600,000.00 to $200,000.00.

Q. At this point did you have any knowledge of what other investors were proposing to Worthen? A. None whatsoever. Mr. Dick Gates was very, very careful not to disclose any of the terms which any of the—information that any

of the other potential investors had given to him, and he assured me our conversations would be held confidential and he would not share the information which I had passed on to him with any of the other investors.

Q. Obviously, as we will find out later, you accepted these specifications with some modification. Why did you accede to the reduction in the option price? A. Well, in looking at the economic realities, we were very unsure of Worthen's ability to exercise at that particular time so, therefore, we discounted that factor a bit.

Q. Did you consider the option prices proposed in the specifications to relate roughly to what the fair market value of the building would be on the date of exercise? A. Yes, we did.

Q. As to the renewal, the reduction in your proposal [58] for rental during the renewal period, why did you accede to that reduction? A. Well, we wanted very much to own the Worthen Bank Building and it was obvious after having received the specifications for sale and leaseback that it was not prepared only for Frank Lyon Company and, in fact, we knew there were other interested investors. We would like to have gotten our $600,000.00, but it didn't look like we were going to be able to negotiate that and accepted a smaller return than we would have otherwise liked.

Q. Did you consider the rental during the renewal period to be fair and equitable in relation to the value of the building at that point? A. Yes, we did.

Q. Ultimately, did you respond to the specifications submitted by Worthen Bank? A. We responded by letter from Mr. Frank Lyon to Mr. Ed Penick.

Q. Is that the letter which appears as PX No. 14? A. Yes, it is.

Q. Would you read that, please? A. Yes. This is a letter dated November 1, 1967 from Frank Lyon to Mr. Ed Penick, president, Worthen Bank and Trust Company.

"Dear Ed: We have reviewed your proposal submitted [59] to us yesterday. Unequivocally we would like to accept

it. However, we do not feel that this proposal is best for Worthen Bank. Therefore, we accept your proposal with one major change. Your lease payments for the first five years will be reduced by $21,000.00 annually. On the enclosed sheet we have listed the points contained in your specifications for an easy comparison of our amended proposal with your proposal.

Ed, as you already know, we want very much to be of service to Worthen Bank. Yours truly, Frank Lyon Company, Frank Lyon, chairman of the board."

Q. And what was Worthen's response to that letter? A. They notified us that they had accepted this second proposal.

Q. Now in the specification that was submitted by Worthen, it reflected that interim financing would be made available by First National City Bank? A. That is correct. The specific sentence contained in Plaintiff's Exhibit 13 states: "Interim financing during construction is to be supplied by the First National City Bank of New York at the prime rate of interest."

Q. Were you then, after your proposal was accepted, furnished any type of commitment letter from First National City Bank in respect to interim financing? A. Well, we knew the initial contact had been made. We went ahead and submitted five year financial statements to [60] First National City Bank. We gave them a brief resume on the history of Frank Lyon Company as well as personal resumes on both Frank Lyon and C. W. Abrams, who at that time was and still is president of the corporation.

Q. Did you receive any communications from First National City? A. We were notified that we—that they would be glad to loan Frank Lyon Company the interim financing due to our ownership of the building.

Q. Did you also receive a commitment letter from New York Life Insurance Company? A. Yes, we did. We had to furnish New York Life Insurance Company basically the same information: namely, five-year audited financial statements, a brief statement of history of the company as well

as personal resumes on the chief officers. And on December 18th, they did write a commitment letter to Frank Lyon Company whereby they offered to loan Frank Lyon Company under certain terms and conditions $7,140,000.00. I think that's Plaintiff's Exhibit 17.

Q. Plaintiff's Exhibit No. 17.

THE COURT: First National City Bank is Exhibit 16?

MR. SAYRE: That is correct, Your Honor. Plaintiff's Exhibit No. 16 is City Bank's commitment.

By Mr. Giroir:

Q. After you received these commitment letters, were [61] there negotiations between Frank Lyon on the one hand, Worthen on the other hand as to the terms of the lease? A. Indeed there were.

Q. Who represented Worthen Bank in those negotiations? A. Dick Gates was the officer which represented Worthen. They were represented by Mr. Dick Williams of Wright, Lindsey and Jennings law firm. He is their legal counsel.

Q. Were there also negotiations between Frank Lyon Company and First National City Bank? A. Yes, there were.

Q. Who represented First National City Bank? A. Mr. Bob Milod, assistant vice-president of First National City Bank. His legal counsel was Mr. John Durkee of Sherman and Sterling, a law firm in New York City.

Q. Were there also negotiations and discussions between Frank Lyon Company and New York Life Insurance Company? A. Yes, they were.

Q. Who represented New York Life Insurance Company in those negotiations? A. New York Life's house counsel or general counsel, Mr. Charles Smith of New York City was the officer for the New York Life Insurance Company. Their local counsel was Mr. Darrell Dover, a partner in House, Holmes and Jewell of this city.

[62] Q. Over what period of time did the various negotiations between the four parties transpire? A. Really from

November or December of 1967 through the first part of May, 1968.

Q. What took so long? A. It's a very complicated transaction and a lot of details to be worked out.

Q. Approximately how many agreements were entered into between the various parties? A. Fifteen or twenty.

Q. In the negotiations, with whom was First National City Bank negotiating in respect to the payment of its note? A. Frank Lyon Company.

Q. And with whom was New York Life negotiating in respect to the payment of its note? A. Frank Lyon Company.

Q. Did Worthen Bank representatives sit in on any of these negotiations? A. Sometimes they did, but only when it concerned additional security that the lenders were requesting.

Q. In respect to the lease between Worthen Bank and Frank Lyon Company, did First National City Bank or New York Life have any interest in the terms of that lease? A. New York Life did because, as the commitment letter points out, one of the securities they wanted from Frank Lyon [63] Company was a conditional assignment of that lease. So, of course, they had an interest in what the lease said.

Q. Over this approximately six months period, there were obviously many negotiating sessions. Where did those occur? A. Most of them took place in Little Rock, Arkansas. Quite a few of them, however, did take place in New York City. I recall either three or four times when I personally went to New York to either meet with representatives of First National City Bank or New York Life to discuss material terms in these documents.

Q. Did the representatives of New York Life or City Bank attend any of the negotiating sessions in Little Rock? A. They attended one or two, but in the main, the negotiations which were held in Little Rock were participated in by the parties who reside in Little Rock.

Q. Inasmuch as you were depending upon receipt of permanent financing from New York Life Insurance Company, whose form or whose format dictated the structure of the transaction? A. The format of New York Life Insurance Company.

Q. Let us turn for the moment to the various agreements that were signed. As between Worthen Bank and Frank Lyon Company, what agreements were executed? [64] A. I believe there were three agreements. There was a ground lease whereby we leased from Worthen Bank ground which they owned, about a half city block on Capitol between Louisiana and Center Streets, a building lease—the ground lease, by the way, is a term of 75 years—a building lease with a term of 65 years for the tower and the other extensions of the building, the lobby and the four or five floors over that. That has got four purchase options in it. It also has options to renew the lease for rental so Worthen can, at their option, extend the terms to 65 years if they wish.

Q. Was there any other agreement between Worthen Bank and Frank Lyon? A. Yes, there was a sales agreement in which we agreed to buy from them and they agreed to sell to us the Worthen Bank Building.

Q. Turning first to the sales agreement, what was the purchase price specified in the sales agreement? A. Seven million, six hundred forty thousand dollars.

Q. How was that figure determined? A. It was outlined really in the specifications for sale and leaseback.

Q. Did it have any bearing or relationship to the anticipated cost of the building? A. Certainly it did because in all of my conversations with Mr. Dick Gates he used the figure of around $7.5 million [65] or between seven million or maybe a little more as far as the total cost of the building. That's what they thought it was going to cost.

Q. When you say "they thought," did they have a construction contract? A. I later learned they did have a construction contract at a cost plus basis.

Q. With no maximum figure? A. That was my understanding.

Q. Had that contract already been entered into at the time that you entered into the sales agreement? A. Yes, it had.

Q. Then in the sales agreement, did you buy the building as is: at that stage of completion and complete it yourself? A. No. It was very important from Worthen's standpoint they maintain a direct relationship with the contractor and the architect and the other consultants they had in the building. It was going to be called the Worthen Building and, quite rightly so, they took a great deal of pride in it and did not want to go through an intermediary in dealing with these parties they had already contracted with.

Q. Did you buy it as it was constructed? A. Yes, we did. Title passed to Frank Lyon Company as they were put in place in the building. I later learned [66] there was another reason. Dick Williams or Dick Gates told me in the meeting at that particular time under Arkansas law state banks were exempt from the sales and use tax provisions of the state revenue code. As long as Worthen was buying it and putting it in the building, they did not have to pay any use tax or sales tax on the materials.

Q. Did you review the plans and specifications which illustrated or showed what the building would be when you bought it? A. I can't really read a blueprint, and we had nice architectural renderings which we saw. Honestly, we didn't really care what the building looked like. We knew it would be a nice building, that it was the desire of Worthen to make it the most impressive office building in the State of Arkansas, and had a great deal of confidence in their abilities and taste to work with the architects and contractors to get it to be that outstanding structure.

Q. Did you require Worthen Bank to undertake to complete its construction? A. Yes, we certainly did. We didn't want to pay for a half completed building or 90 percent completed building. We elicited from them covenants and warranties that the building would be completed in accordance with the plans and specifications.

Q. Was the building to be situated on land owned by [67] Worthen Bank? A. Yes, it was.

Q. You referred to ground lease. A. That's correct.

Q. What was the length of time over which that ground lease extended? A. Seventy-five years.

Q. What were the lease payments during the first 25 years? A. The sum of $50.00.

Q. What were the lease payments during succeeding years? A. They begin at a hundred thousand dollars per year for five years and then escalated by $50,000.00 until they reach two hundred fifty.

In other words, for the first five-year period it was a hundred thousand; for the next five-year period a hundred fifty thousand dollars per year; then two hundred thousand per year for the next five years; then two hundred fifty thousand per year for the next five years. And it remained at $250,000.00 for 20 years, and for the last ten-year period it was ten thousand per year.

Q. Why was the ground rental during the first 25 years only $50.00? A. Well, we were really viewing this in relationship with the building lease and talking about the net economic [68] impact. We could have made it any figure we wanted to and we would have passed it on to Worthen in the building lease. It seemed a lot simpler to do it this way.

Q. Do I understand in the building lease you, in effect, subleased the ground back to Worthen Bank? A. That's correct.

Q. Did you specify a charge in the building lease for that sublease of the ground? A. No.

Q. If you had had a material lease provision or lease payment under the ground lease, would you have increased the building lease by roughly the same amount? A. We certainly would have. If the ground lease had been leased to us at, say, $50,000.00 a year, we would have increased the rentals on the Worthen Bank Building by 50,000 a year.

Q. During the first 25 years of the building lease, approximately what was the annual rental? A. It was approximately $580,000.00 annually for the first ten or eleven years, and then it went to approximately 600,000 for the next—

up to the 25th year. At that time it dropped to 300,000.

Q. How did the five hundred eighty and six hundred twenty figure relate to the payment that you were required to pay New York Life? [69] A. They coincide identically with them.

Q. That is during the first 25 years? A. During the first 25 years.

Q. During the renewal period, how does the $300,000.00 annual rental relate to the amount you would owe New York Life? A. We wouldn't have owed New York Life anything after 25 years.

Q. Do I understand during renewal period the rental income would be net to Frank Lyon Company? A. Absolutely. It is cash in our pocket.

Q. I'd like to focus for a minute on the relationship between the ground lease during the 25th to the 75th year as opposed to the building lease if you assume that Worthen elected to exercise its renewal. I understand that the building lease continued for 40 years at a constant rate of $300,000.00. Is that correct? A. The rental terms, yes.

Q. The ground lease escalated from a hundred thousand to $250,000.00. A. True.

Q. From the 25th to the 65th year. A. That's correct.

Q. What net effect or net rental, therefore, was Frank Lyon to get during the renewal period? [70] A. We would have received a net rental income of $200,000.00 during the first five years; a hundred fifty during the second five year period; a hundred thousand during the third; 50,000 during a 25 year period, and then the building lease terminated.

Q. The net rental in the aggregate, therefore, during the five years, 25 to 30, would be approximately a million dollars? A. That's correct.

Q. In the second year it would be in the aggregate of approximately $750,000.00? A. That's exactly correct.

Q. And so forth down to the last period.

Now at the end of the 65th year, Worthen had no option to renew its lease; is that correct? A. That is correct.

Q. At that time Frank Lyon Company had a continuation of the written ground lease for a period of ten years. A. For a period of ten years at an annual rental of $10,000.00

Q. And that $10,000.00 during the year 65 to 75 compares to $250,000.00 ground rental during the year 60 to 65; is that correct? A. That's correct.

Q. Why the drastic reduction from the year 65 to 75 in the ground rental? [71] A. We were very, very concerned about what would happen to our building at the end of the 65 year period and wanted to as a possibility of really maximizing our return on this real estate investment, negotiate with someone, hopefully with Worthen to lease the building over a ten year period at fair market values, whatever they happened to be at that time.

Q. So that if Worthen continued its building lease at 300,000 a year that would be, in effect, 290,000 per year net to you during that ten year period? A. That's correct. A total of $2.9 million.

Q. Was the arrangement as to the 65th to the 75th year specified in Worthen's specification for bids? A. It was not listed in there, no. This is one of the many points we negotiated during this six month period between the time that we first started negotiating and the time that all the documents were signed.

Q. And in those negotiations, would you paraphrase what your negotiating position or request was? A. Well, it was—since it was our building, we wanted to go ahead and were very concerned really about what position we would be in as the owners of the building at the end of the 65 year period. We felt like it would be to our advantage to go ahead and have a fixed ground rental of 10,000 a year during that time which would give us an additional ten year period to either negotiate additional rentals from Worthen—[72] as you point out, even if you keep it the same, the $300,000.00 level over that ten year period of time, that's net income to the company of $2.9 million. This was really an economic advantage that we negotiated during the six month period.

Q. If Worthen had these options at the end of 11 years 15 years, 20 and 25 years, to buy the building, why were you concerned in what was going to occur in the 65 and 75th year? A. The option only ran one way. That was their choice. I had no idea as to whether they could or want to exercise. I did know at that time they could not have exercised or could not have owned the building.

Q. After the 75th year you no longer had an option or have no option to renew the ground lease. A. That's correct.

Q. What occurs in respect to the building at that point? A. I was also very concerned about this so received an opinion from Mr. Bill Nash of the Rose law firm as to the ownership. He told me that the building still is the property of the Frank Lyon Company.

Q. So you would still be entitled to receive rental income or to sell or otherwise deal with the building after the expiration of 75 years? A. That is absolutely correct. The building does not [73] revert to the land owner unless the lease so specifies and this does not.

Q. In view of the options, why were you concerned with what would happen at the end of 75 years? A. At the time the documents were being negotiated, Worthen Bank could not own the building. I knew of no reason why they would be able to own the building. And, secondly, if they could, it would only cut one way.

Mr. Sayre: I object to that line of testimony. He hasn't shown any particular knowledge as to what the workings of the Worthen Bank and their reasons and their abilities. I think it would be proper to elicit it from a representative of Worthen Bank and not Frank Lyon Company.

The Court: Well, the agents of the Frank Lyon Company had certain attitudes of Worthen's ability which bear upon the intention of the parties, and the objection will be overruled, whether they were correct or not.

By Mr. Giroir:

Q. Turning to the financing documents—

The Court: Just a moment. You say at the end of the 75 years, the lease—you would still own the building?

The Witness: This was the legal opinion we received from the Rose law firm. Yes, Your Honor.

By Mr. Giroir:

Q. Turning to the financing documents as between Frank [74] Lyon Company and New York Life Insurance Company, what agreement did you enter into? A. We entered into a note purchase agreement.

Q. What other agreements? A. We, of course, executed a $7,140,000.00 promissory note.

Q. What other agreement? Was there an assignment of a lease? A. There was an assignment of a lease, a conditional assignment of the lease to New York Life Insurance Company.

Q. Let me ask you: The agreement we have mentioned a minute ago: the sales agreement, the ground lease, building lease, and the agreements you are talking about now: the note purchase agreement, the notes and the assignment of lease and the other agreements we will refer to in a minute, were these all executed simultaneously? A. The—most of them were. I don't believe all of them were executed simultaneously. They are dated, however. You are referring also to which specific agreement? A. To each of the agreements.

Q. I'm not sure what the date of the sales agreement is. I could check it.

Q. In point of time, were they roughly signed at the same time? A. Yes. They were negotiated during this six month [75] period, and at the end they were all finalized and executed by the parties to those particular agreements.

Q. In respect to the note purchase agreement between New York Life on the one hand and Frank Lyon on the

other hand, what was the import or the thrust of that agreement? A. Well, the note purchase agreement was New York Life's agreement to lend to Frank Lyon Company $7,140,000.00 subject to certain terms and conditions. We had to go ahead and sign a $7,140,000.00 note. We had to assign to them a building lease which, in fact, met their approval. We also warranted our five year audited statements which we previously furnished them. And we were also required to furnish throughout the term of the note audited financial statements on Frank Lyon Company.

Q. Was Worthen Bank a party to the note purchase agreement? A. No, sir, they were not.

Q. Was Worthen Bank a party to your promissory note to New York Life? A. They certainly were not.

Q. Did they guarantee that note? A. No. In no way did they guarantee the payment of that note.

Q. Is it your understanding that in the event of your default on that note that Worthen would be required to pay the [76] note? A. That is not my understanding.

Q. Does the note contain provisions for acceleration of your obligation in the event of your default? A. In the event of our default it does.

Q. Would those accelerated provisions accelerate Worthen's obligations under the lease agreement? A. No.

Q. Did Worthen Bank enter into any agreement to induce New York Life to enter into the sales agreement with you? A. Not in the sales agreement, no. Into the note purchase agreement I believe they did execute a consent and agreement, yes.

Q. In that consent and agreement, what did they consent and agree to? A. They consented to the assignment of the lease. They also consented to go ahead and subordinate their interest in the parking deck and their interest in the ground to the deed of trust, which we would execute with New York Life.

Q. Did they also agree to cause the building to be constructed in accordance with plans and specifications? A. Yes, they did.

Q. As to the interim financing, what agreements did Frank Lyon enter into the First National City Bank? A. We signed a $7 million promissory note.

[77] Q. Was there any other agreement or undertaking between First National City Bank and Frank Lyon Company? A. Yes, there was a building loan mortgage in which we mortgaged our building to First National City Bank. There was also a building loan mortgage agreement which contained some other covenants and warranties of Frank Lyon Company. Then there was a guaranty of construction and completion which Worthen Bank signed in favor of First National City Bank, in which they affirmatively covenanted to cause the building to be constructed.

Q. Just as a point of curiosity, the purchase price under the sales agreement for the building was $7,640,000.00. A. That's correct.

Q. The permanent loan was $7,140,000.00. A. That's correct.

Q. And yet the interim loan was only $7 million. A. That's correct.

Q. Why the discrepancy between the interim loan and the permanent loan? A. Well, at that particular time, we did have some excess funds which we did not mind inflowing in the construction of the building, so took funds from the working capital rather than increase the amount of the interim loan.

Q. So immediately prior to drawing on the permanent loan, what aggregate dollar amount of investment of your own [78] capital, of your own dollars, did you have in the building? A. We had $7,640,000.00 invested in the building. We had borrowed from First National City Bank $7 million, so in real estate parlance our equity at that point was $640,000.00.

Q. When you drew on the permanent loan, what amount did you receive? A. Well, we borrowed as the note shows $7,140,000.00 from New York Life.

Q. And you applied how much to repay your building loan agreement to First National City? A. Seven million dollars.

Q. And what did you do with the balance? A. Put it in our bank account. Used it to pay salaries and buy more inventory.

Q. Did Worthen Bank enter into any guaranty agreement whereby it guaranteed payment of your interim construction? A. Not to my knowledge they didn't.

Q. Did they sign the note? Did they endorse it? A. They neither signed nor endorsed the note. Frank Lyon Company is the only maker in the $7 million note to First National City Bank and is the only maker in the $7,140,000.00 note in favor of New York Life.

Q. Did they undertake to do anything in the event that the permanent loan for some reason was not closed? A. I believe in the consent and agreement they covenanted [79] to sit down and work out with First National City Bank a lease acceptable to them which would then be assigned to First National City Bank.

Q. But that was only in the event the permanent loan did not—A. That's correct.

Q. Again, this was the loan—your commitment to purchase the building, was it predicated upon receipt of a permanent loan? A. No, it was not.

Q. In the building loan agreement, did you enter into any guarantee as to construction of completion to First National City Bank? A. Let me refer to the building loan agreement, if I may.

Yes, we do, and on page three of Plaintiff's Exhibit 21 we do express our covenant to cause to be erected on the land the Worthen Building in accordance with the construction contract, et cetera. Yes, we did.

Q. The options which were contained in the lease agreement between Worthen Bank as lessee and Frank Lyon as lessor matured at the eleventh, fifteenth, twentieth and twenty-fifth year.

Q. These are with the options to purchase? A. Yes. [80] Q. Were there any other options running in favor of Worthen Bank to purchase the building? A. Yes. In the event of the insolvency of Frank Lyon Company, they had the option to go ahead and purchase the building at the appraised value.

Q. At what price? A. At the appraised value.

Q. Do you recall why that provision was included in the sales agreement? A. Well, Worthen did want the right if Frank Lyon Company went into default to be able to buy the building and perhaps resell it to another investor that was not insolvent.

Q. But it would have that right during the first 25 years at five year intervals? A. No. There were only four specific dates at which they would have it, and if we went insolvent on any other date those particular option periods would not help them any.

Q. And the purchase price under that option was what? A. Appraised value.

Q. How was that to be determined? A. By getting two appraisers and taking the price and dividing it by two.

Q. We are now to the point where you have entered into all the agreements with Worthen to buy the building, with [81] lenders to lend you the funds. Mechanically how did you obtain funds from First National City during construction?

The Court: Let me interrupt there since we are turning now and I note the time. I suggest we may want to recess for lunch. Let me ask a few questions.

I am not sure I understand the situation about building the building and Worthen had a contract directly with—

The Witness: With Matson Bellow, a joint venture.

The Court: And it was a cost plus contract?

The Witness: That's correct.

The Court: And they had an obligation under these documents to complete it in accordance with the plans and specifications?

The Witness: Yes.

The Court: Did it have any—would it have had any effect upon the transaction had the cost gone to nine million?

The Witness: Well, Worthen Bank would have still been obligated to go ahead and complete the building at whatever cost. If it cost them nine million they would have had to have completed building.

The Court: And it would not affect the agreement here?

The Witness: That's right. We still bought the building for $7,640,000.00.

[82] The Court: What, if you know, was the reason for the apparent altruism expressed in the November 1 letter about, in effect, reducing what you were regarding unilaterally: the $21,000.00? You are saying this whole agreement is not really the best for Worthen and "we accept your proposal with one major change. Your lease payment for the first five years will be reduced by $21,000.00 annually."

The Witness: We knew there were other very, very interested investors and we were most anxious to own the building. They had asked us when they gave us the specifications for the sale and leaseback to respond in that general format or if there were any modifications to let them know on the letter form. We were thinking that another bidder might just say, "Yes, I will take the building under the terms and conditions outlined in the specifications for sale and leaseback." We wanted to underbid them.

The Court: In other words, you wanted to accept it plus?

The Witness: That's correct. And we just didn't——

The Court: What thought, if any, if you recall, went into the decision to offer to reduce it by $21,000.00 as opposed to some other figure?

The Witness: We were kicking around the idea of reducing it by about a hundred thousand and we thought maybe someone else did that, so we just bettered them $5,000.00, making [83] it $21,000.00 for five years or a hundred five thousand.

The Court: I see.

Just one other question before we recess. The financing on the Twin City came from what bank?

The Witness: Republic National Bank of Dallas, Texas.

The Court: All right. How are we going? Are we losing ground?

Mr. Williamson: I think we are going a little slowly because of the length of time in the opening statements and, consequently, to be sure to get through in two days I suggest you be a little light on the lunch hour.

The Court: Why don't we be in recess for one hour. Court will be in recess. We are going to have to make it until 1:15 because I have an appointment at 1:00.

Court will be in recess until 1:15.

(Whereupon, at 12:00 noon, the above-entitled proceedings were in recess, to reconvene at 1:15 p.m., the afternoon of the same day.)

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[84] By Mr. Giroir:

Q. Ralph, when we terminated a minute ago we were discussing the sales contract and the fact that you bought a building that was under construction—that is, that Worthen Bank had under construction on a cost plus contract. A. Correct.

Q. Now I asked you earlier how you arrived at the $7,640,000 purchase price. Would you state your answer to that again? A. That was the best estimate at the time of the actual cost to complete the building.

Q. When you say "the building," what do you refer to? A. The part of the building that you typically think of as being a building, excluding the specialized leasehold improvements such as the way one tenant or law firm may want a [85] library done or the way certain tenants want certain paneling in the offices and excluding the specialized banking fixtures: vault doors and other things that a bank would want to put into any facility that it occupied.

Q. Did you have any information as to whether Worthen had gotten estimates on what the cost of the building would be? A. This was only through oral conversations with them, and it was their consensus of thinking it would be $7,640,000.

Q. When you agreed to pay $7,640,000, did you do so with the realization that they may make a profit on you? A. Yes. But we felt like that would be a fair purchase price to pay for that office building and that location.

Q. Did you anticipate that Worthen would have to expend a substantial amount of its funds for leasehold improvements? A. Yes, for the peculiar purposes of any bank they do require specialized teller equipment and vault doors and safety deposit boxes that we really were not interested in owning or do not want to purchase. It was understood by both parties that Worthen would go ahead and purchase these and make minor improvements to the building to make it suitable for Worthen's peculiar purpose as a banking institution.

Q. The type of things that you would classify as leasehold improvements for these purposes, would it include the paneling on the walls? A. Yes.

[86] Did it include interior partitions? A. Yes.

Q. What other types of items? A. Carpeting on the floor. I have already mentioned specialized banking equipment. Certainly heavy vault doors.

Q. What about consulting or other types of fees paid? A. Well, certainly anything that had to do with the interior design of the building as far as where you wanted to use oak paneling or a darker wood would really be up to the tenant. Painting on the walls, whether it was going to be white or a bright color.

Q. Did you care what the structural portion of the building looked like? A. As far as the architectural design, no. We did care that it was an attractive building and had the utmost confidence or realized that Worthen wanted it to be an attractive building and had confidence in the architects and had seen architectural renderings of the design of the building. We were not interested in paying $7,640,000 for a run-down or unattractive piece of real estate.

We did care if it was an attractive building and in that sense cared what it looked like. The fact that it might have been colored white instead of maybe some aesthetically pleasing design of black and white or bronze glass didn't concern us that much.

[87] Q. Turning again to the mechanics by which funds were disbursed to you from First National City Bank to fund the construction of the project, how were funds delivered to you? A. Frank Lyon Company opened up a regular demand deposit account at First National City Bank. I think the initial deposit was something like a hundred dollars. After we submitted our written request to First National City Bank, they would credit our account in their financial institution with the amount of our requested draw on the loan.

At that time, after we received notification of this, I would go ahead and write a regular company check and deposit it in another account of Worthen's which was at Twin City Bank.

Q. An account of Worthen's? A. Either at Worthen or at Twin City. We had two accounts. This particular account was at Twin City Bank.

And we would then deposit a check drawn on Frank Lyon Company's account with First National City Bank on our account at Twin City Bank and would transfer the funds down to North Little Rock in that manner and then would go ahead, as required, and make disbursements or reimbursements to Worthen, provided they had satisfied the requirements.

Q. What requirement did you impose upon Worthen to justify or to obtain a draw? A. It was laid out in the sales agreement. We required four things: we required either an architect or consultant's [88] certification that the amount of the materials had really been, in fact, put in place in the building and had been expanded; we required an independent C.P.A. firm's opinion as to the result of their audit of these particular bills and disbursements to show they had actually been paid and were, in fact, stated correctly; we required schedules showing what portions of the building had been completed so we'd have more detailed access to the information as to what went into the building; lastly, we required an affidavit from an officer of Worthen Bank who was the overseer of the construction saying that he was really familiar with these transactions and made certain warranties and representations or that Worthen Bank did that the figures were correct.

Q. Of the documents that you required of Worthen, how many of those documents or what part of them were required of you by First National City? A. I think only two of the four were required of First National City.

Q. Which two were those? A. I think that was the architect's certification as to the percentage that was completed and the C.P.A.'s audit of the figures and funds actually put into the building—disbursed.

Q. Why did you require the additional documentation? A. Because we wanted to make sure that they put $7,640,000 in the building. We wanted to make sure it was [89] going in there and wanted to get these other warranties and representations affirmatively sworn to by an officer of Worthen Bank as additional protection to us.

Q. At the time the building was completed, how were the funds mechanically transferred from New York Life to you? A. New York Life gave me a check payable to Frank Lyon Company in the amount of $7,140,000.

Q. Incidentally, where was that closing? A. The closing was actually in the building—in the completed Worthen Bank building in Little Rock, Arkansas.

Q. And New York Life delivered a check to Frank Lyon Company? A. To Frank Lyon Company. I endorsed that check and deposited it in Frank Lyon Company's checking account.

Q. Then what did you do with the deposit or the funds in Frank Lyon's checking account? A. That same day I had given written instructions to an officer of Worthen to wire the funds through the Federal Reserve System to First National City Bank in payment for our interim loan.

Q. When you say "wire the funds"—— A. Wire funds. Wire $7 million.

Q. And the balance of the funds, what happened to it? A. They just stayed in the checking account.

Q. What documentation do you require of Worthen in [90] connection with your drawing down the permanent financing? A. Well, basically the same—I am sorry. That we required of Worthen?

Q. Yes. A. With regard to drawing down the permanent financing?

Q. With regard to that? A. The drawing down of the permanent financing was Frank Lyon Company's responsibility.

Q. Right. But did you obtain any assurance for your own protection from Worthen before you drew the funds down? A. Okay. We did get affidavits that the building had been completed in accordance with the plans and specifications attached and also required as-built plans and specifications.

Q. You testified that you were involved in the decision at Frank Lyon Company to make this investment.

The Court: Let me back up a moment to the mechanics. You said you took title to the building piecemeal from time to time.

The Witness: Yes, Your Honor.

The Court: What were the mechanics of that?

The Witness: Well, according to the legal instruments the title passed to Frank Lyon Company as the building—as the material was actually placed in the building.

The Court: I'm just curious as to the type of instruments. What would it be? That additional space or the [91] third floor—how did you piecemeal take title?

The Witness: There was a lot of conversation struggling with that very legal issue. You can get discussion on any legal issue when you have three or four lawyers involved, but we did spend a great deal of time discussing that and finally decided that in the context of the sales agreement that we had, in fact, purchased materials when they were actually put in place and became a part of the real estate.

The Court: All right.

By Mr. Giroir:

Q. Did we, for our own clarification, describe that as brick-by-brick? A. That was the phrase we referred to. We were buying the building brick-by-brick.

Q. Would you state the reasons why the Frank Lyon Company entered into this investment? A. For many years or for the years immediately preceding the possibility of our entering into the transaction it had been a stated goal, and perhaps the most important goal of the company, to obtain some diversification. We realized that the future of our company really hinged upon our contractual arrangements with two major suppliers: Whirlpool and RCA. These contracts could be canceled, really, on 30 days' notice almost at their whim. We felt it was very important for the continuing existence of the corporation to diversify into [92] other areas.

Q. Were you at that time enjoying good earnings? A. Yes, we were.

Q. Were there other reasons? A. Yes, there were. Also at this particular time color TV sets were really in demand and we were able to sell all of them we could get and were making quite a bit of money and did have some surplus funds to invest.

As an accountant I was also cognizant of the potential challenge down the road which the service might make as far as accumulated earnings, and it was in the best interest for the company to go ahead and invest those funds in some other investment to protect ourself against a penalty tax under 531.

Q. Were there other reasons? A. Yes. Most all of the members of the executive committee were familiar with real estate transactions and had had experiences investing in real estate. Specifically, I was secretary-treasurer of several real estate corporations which paid a management fee to Frank Lyon Company, reimbursing them for my time that I spent which had similar investments, such as the IBM building, Safeway office building, National Cash Register office building.

The Court: The executive committee of your board of directors?

The Witness: Yes ,that's correct, Your Honor. It [93] was at that time Mr. Frank Lyon, Mr. C. W. Abrams, and Mr. Nash Abrams. I believe Mr. Dick Woodmansee also at that time.

By Mr. Giroir:

Q. Were there other reasons? A. Yes. As financial officer for the company I realized it is very important to obtain good relationships with your primary bank, and Worthen was our primary bank. Personally I felt if we

could go ahead and have a long-time mutually profitable relationship between them this would, in a sense, cause them to look more favorably upon us for future needs of credit down the line should anything else come on the horizon.

Q. Any other reasons? A. Just analyzing the investment itself, it seemed to be a very profitable investment for Frank Lyon Company. While, as owner of the building, we would be able to select various methods of depreciation under the Internal Revenue Code, either straight line or one of the accelerated methods, if we elected an accelerated method this would be a tax shelter for the early years. In fact, an analysis showed we would shelter in the aggregate about $3 million of taxable income during the early years and, in effect, save for a time about a million and a half in income taxes.

Also during this time we had an investment in which we were continually building up an equity in the building, and although that was no immediate cash flow, as far as the [94] difference in the rental income we received and the amount required to service New York Life debt, at the end of the 25 years we would have owned and will own the building free and clear, a building which it cost $7,640,000.

Q. Any other reason? A. Well, yes. Continuing in the time frame, should Worthen at that time elect to exercise its option to rent the building, we would receive both pretax and after tax cash flow. Since we would have no payments to New York Life or any other lender, we would receive the rental income and our expenses directly related to that building would be the ground rent, which I discussed earlier, and this would be a net cash profit to the company.

If the building lease continued at Worthen's option to renew to the end of the 65 years, we would then be in a position of having them obligated under the ground lease for a 10 year period requiring us to pay $2,000 a year. I don't know what the fair rental value of that building

will be in 50 years at the initial time, 65 years from the date that the agreements were entered into; but even if you assume a continuation of the same building rent of $300,000, this would mean that in each year we would receive in excess of a quarter of a million dollars, specifically $290,000 for the 10 year period. That's an aggregate of $2,900,000.

Q. Any other reasons? [95] A. As I think I mentioned this morning, I was very concerned about what was going to happen after everything was said and done and somewhat hopeful I'll be alive to see it although I'll be ninety some odd years old.

We did obtain a legal opinion from Mr. Bill Nash of the Rose law firm that title would still remain in Frank Lyon Company and this would be, then, a very, very valuable asset of the company at that particular time which we could perhaps sell back to the owner of the ground or take whatever steps we wanted to do to either continue to rent it or perhaps otherwise dispose of the asset.

Q. Let me for a moment quantify the types of financial inducements you felt you had. Let me talk about them with you in terms of the pure economic rewards and rewards giving consideration to tax benefits.

It seems that the pure economic rewards you referred to are primarily the renewal of the lease which will net you how much in the aggregate, approximately? A. It will be several million dollars. About—over which period are you talking about?

Q. The full 25 to 75 years—your projections. A. May I refer to my schedule?

Q. Yes. That's PX-36, I believe. A. Were you referring to the gross rental income or the net rental income after we deducted the amount due to the [96] ground lease?

Q. The net. A. All right. The net will be a hundred thousand dollars for a five year period which would be—

I'm sorry—a hundred thousand dollars for the five year period, which would be $500,000.

Q. Let's start backwards. During the last 10 years you are going to net how much? A. If you assume that we will continue to rent the building to Worthen for $300,000, we will net $290,000 per year. For the 10 year period that's going to be $2,900,000.

Q. And then you've got what, four five-year periods? A. There's a 20-year period or 25-year period. I think it is in the ground lease referred to as four five-year periods and then an additional 20-year period.

Q. And in each of those five-year periods you will net how much? A. Well, in the——

Q. Is it 250? A. Let me refer to the ground lease, if I may, which is Plaintiff's Exhibit 18.

During the time from the 25th year to the 30th year the building lease calls for rental to be paid to Frank Lyon Company in the amount of $300,000. We have to pay $100,000 per year on the ground. That's a net of $200,000 for the five-year [97] period, which would be a million dollars in hard cash.

For the second five-year period the net is $150,000 times five is three-quarters of a million dollars or $750,000.

In the third five-year period the net is $100,000 a year —that's net income to Frank Lyon Company—times five is $500,000. And then for a 25-year period there is a net of $50,000 per year, which would be a million and a quarter.

Then for the last 10-year period we don't know what the building rental will be, but if you assume a $300,000 annual building rent, it would be $2,900,000 in the aggregate.

Q. So, roughly, $6 million? A. $6 or $7 million, yes.

Q. And does that, to you, seem like a substantial benefit? A. It certainly is to me.

Q. Now there's been much conversation this morning in opening statements about there being no inducement to make the investment other than the tax benefits during the 25-year period. Does Frank Lyon individually or the company have any history of making investments that have no benefits other than following the termination of the initial lease? A. They certainly do. There are several buildings which are owned by corporations where the sole function of the corporation is just to own those buildings. Specifically the IBM building in the Industrial District, Stover Medical Supply [98] building also located in the Industrial District, National Cash Register building located in the old Safeway Office Building downtown, a retail store which, incidentally is built on leased ground in Springfield, Missouri, which was originally leased to Gibson Products Company and now leased to Handy Dan Home Improvement Center.

All these real estate investments are held by and owned by separate real estate corporations. The stockholders receive absolutely no tax benefit from them.

In all of them the rental payments are approximately equal to, although not identically equal to, the amount required to service the debt. In those cases we either elect a straight line method of depreciation or sometimes we effect an accelerated method of depreciation and do go ahead and create net operating losses that can be carried forward in that corporation for five years.

Q. Is there any income in those corporations to offset the net operating loss? A. No. The corporations only own that particular real estate.

Q. Do the corporations have any value in the real estate other than the residual value? A. That's all they have. Rental income is approximately equal to debt service. There's a little bit left over to pay Arkansas franchise tax and a management fee that goes to Frank [99] Lyon Company for my time that I spend on them.

The whole design is that after the mortgage is paid the corporation will own free and clear the real estate.

Q. Looking only at the residual value then, are these investments any different from the Worthen Bank Building? A. None whatsoever.

Q. Turning then from the non-economic to the tax benefits, did you elect an accelerated method of depreciation? A. Yes, we did.

Q. What benefit does that result in? A. Well, in the early years allows deductions in excess of the rental income. In the later years we have excess income if you will, over and above the deduction. So what we do is save income tax in the early years and pay more income tax in the later years.

Q. Do you know at what point in time in this lease that the tax shelter becomes a negative tax shelter? A. Yes. In 1980 is the last year that we shelter any income. We only shelter about $25,000 in that year.

Q. In the period up to 1980 approximately how much income and approximately how much tax do you save in the aggregate? A. We shelter approximately $3 million dollars in income and, therefore, save a little over one and a half million dollars in income tax.

Q. During the years from 11 through 25, approximately [100] how much negative shelter do you have and approximately how much tax do you incur? A. We would be paying approximately a million and a half in taxes over the last 15 years of the lease. In 1993, for example, our tax liability would be, according to these projections, about $228,000 in that one year based on this transaction only.

Q. Would that be the highest year? A. No. In 1994 it's $232,000. About a quarter of a million dollars a year.

Q. That's the highest amount of negative tax shelter? A. Yes. Now I'm speaking of the income tax we would actually pay. The negative shelter is closer to half million dollars. My computations show that in '92 for example, we will have taxable income of $436,000; in '93 about $477,000 taxable income.

Q. That's income which you are paying taxes on for which you are not receiving cash flow? A. That's correct.

Q. In view of that, what would induce you or what did induce you to elect the accelerated method? A. It's really the economic concept of a current dollar being worth more than a future dollar. There's a real economic benefit to us in being able to shelter approximately $3 million of taxable income in these first 10 years and, in effect, save approximately one and a half million dollars of income tax. [101] Q. Did you do anything specifically with the dollars that you sheltered? A. Yes, we did. I mentioned earlier that it had been the stated objective of the corporation to go ahead and diversify. Fortunately, very shortly after this transaction was completed we learned that both the majority stockholders in Coca Cola Bottling Company and the Twin City Bank were going—wanted to sell; and really were in not for structuring our ownership of the Worthen Bank Building in this way, we would not have been able to purchase both Twin City Bank and Coca Cola. We could not have paid for them.

Q. Would you elaborate on that? Exactly how did this tax saving enable you to pay for Twin City Bank and the Coca Cola Company investment? A. Well, we were able to reduce our tax liability in 1969 by approximately $237,000. In '70 we reduced it by approximately $294,000 dollars and about $212,000 in '71.

This means that the corporation was able to retain dollar amounts of approximately a quarter of a million dollars a year that otherwise would have gone in the United States Treasury. We were able to take those dollars and pay them out to third parties: namely the ex-shareholders of Twin City Bank and Coca Cola, in order to acquire those investments.

Q. If you had not made these investments, would you have been able to accumulate cash? [102] A. Yes, we would have.

Q. Did you accumulate sufficient cash to pay the full payment for these investments? A. No, we did not. It was necessary in both instances to go ahead and obtain outside financing to pay the entire purchase price. The majority stockholders from whom we purchased the majority of shares in the Twin City Bank wanted a cash settlement. It was bought from the estate of H. L. Tupp. They just wanted cash.

We were able to go ahead, partially through our own funds and partially through negotiating a loan with Republic National Bank, acquired the funds. However, in negotiating the loan with Republic National Bank we were able to use our tax savings in subsequent years to, in effect, repay that debt and were not required to rely solely upon Twin City Bank's paying a dividend it Frank Lyon Company to enable us to service the debt. As a matter of fact Twin City Bank has never paid a cash dividend since the time Frank Lyon Company acquired the stock. They have retained all earnings for their own internal purposes.

Q. Of the initial purchase price for Twin City Bank stock, do your records reflect how much you paid cash out of the corporate funds and how much you paid out of the proceeds of the loan? A. Honestly, most of it was borrowed from Republic [103] National Bank but with the idea of keeping the tax savings on this venture to help us service the debt in future years. That was on a 10-year loan.

Q. Has it been serviced? A. Yes, it has. Never missed an interest or principal payment.

Q. With respect to the investment in the Coca Cola Company, how much of your own funds did you use in that instance? A. It was 29 percent of the purchase price. The selling stockholders were very insistent on getting that amount in cash. We, at that time, had to borrow, I think it was, a half million dollars from Worthen to make that cash payment. The selling stockholders also wanted the balance for the remaining 71 percent over a relatively

short period of time. Specifically, they wanted it over four years with interest, of course.

Q. I believe you testified this morning that the aggregate down payment for Coke stock was approximately a million dollars. A. I think that's correct.

Q. So you paid—— A. Yes.

Q. ——then, 500 out of your corporate funds, borrowed 500 from Worthen, and entered into note agreements with other stockholders obligating you to pay approximately $2,000 over what period of time? [104] A. Well, the balance was payable over a four year period. Four equal installments of principal, plus interest.

Q. Have those been paid on time? A. Yes, they have. Every one of them.

Q. Have those investments been good investments? A. They have been very good investments for us.

Q. Approximately how much per year do those investments contribute to the earnings of Frank Lyon Company? A. We account for those things by reporting our equity in earn consolidated subsidiaries. This year after taxes Coca Cola Bottling Company will earn approximately $750,000. Twin City Bank will earn after taxes approximately $700,000.

Q. Do you think the investment in those companies and the earnings they have generated justifies you in being penalized with this negative tax shelter? A. They certainly do, because there's no way we could have paid for and acquired both of those investments under the terms that we did pay for them without a tax shelter.

Q. Now when Frank Lyon Company entered into this transaction did it intend to be a mere accommodation party for Worthen Bank? A. Absolutely not.

Q. Did it intend to be a straw man? A. Absolutely not.

Q. Is Frank Lyon Company's general credit obligated on [105] the note to New York Life Insurance Company? A. It quite clearly is. I also point to the requirement in the note purchase agreement where we do warrant our finan-

cial statements for five preceding years and also are required to furnish them audited statements—they want two copies, incidentally—for every year that the note is still unpaid for the 25-year period.

Q. On those financial statements how do you reflect your ownership of the Frank Lyon Company? A. We show that as an asset, originally of $7,640,000. Since it is a depreciable asset, we reflect it at the original cost, less the accumulated depreciation. And today it's on the books for a little over $6 million.

We also carry, of course, the note payable to New York Life on our balance sheet as was the note to First National City Bank until it was paid.

Q. Does Frank Lyon Company have any agreement—written, oral, implied, or otherwise—with Worthen Bank under which Worthen Bank agrees or promises to exercise its option? A. To my knowledge they do not.

Q. Does Frank Lyon Company have any form of agreement with Worthen Bank whereby they agree to pay Frank Lyon either its $500,000 equity investment or to hold it harmless from loss on its $7,140,000 note obligation? A. To my knowledge, no, they do not. Such an agreement [106] does not exist.

Q. At the time of these agreements, was it your intention of the other parties of Frank Lyon Company to become the owner of the Worthen Building? A. We clearly intended to be the owner and are the owner of the Worthen Building.

Q. The obligation which appears on your balance sheet for $7 million approximately to New York Life now. How long will that appear on your balance sheet? A. For 25 years.

Q. Will that have any effect on your corporation operation? A. It certainly will. One factor all creditors look at is who else you owe, and the fact that we have borrowed this amount of money from New York Life Insurance Company does restrict the additional amount of money we might borrow from another financial institution.

Q. Did either New York Life Insurance Company, First National City Bank, or any other party in the transaction to your knowledge consider or treat Frank Lyon to be anything other than the owner of the building? A. No, sir, they did not.

Mr. Giroir: I have no other questions.

The Court: Are all the agreements between the plaintiff and Worthen and the banks with respect to this transaction [107] in writing and here before us?

The Witness: Yes, Your Honor, they are.

The Court: There are no other outside oral or other agreements of any kind?

The Witness: Not to my knowledge.

The Court: Any further questions?

Mr. Giroir: No.

The Court: Mr. Sayre, you may cross examine.

CROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Cotham, I have caused to be served on you a subpoena to bring with you the calculations that you prepared for Frank Lyon Company with regard to this transaction and the financial tax position it put the company in. Have you brought any of those requested documents or do you have any? A. Yes. Our entire file is sitting in the back of the courtroom on that bench in a brown envelope.

Q. Would you please produce or get the file relating to the calculations that you made?

Mr. Cotham, in going through your files have you located any original copies of calculations you made concerning the economic tax position of the company if it entered into

this arrangement with Worthen Bank? A. Mr. Sayre, after the negotiations were completed and the documents signed, I went through and did clean out the [108] files. I have, however, reconstructed the benefits that we looked at at the time, and these schedules do—Plaintiff's Exhibit 36 corresponds to my best recollection to exactly what we looked at at the same time we were looking into going into this proposition.

Q. And you were planning to use—the company was planning to use the double declining balance method of depreciation? A. Yes, we were.

Q. Was the idea to shelter income from the appliance business? A. Yes.

Q. The depreciation deduction is actually a paper transaction. There is no cash pay for that amount, is there? A. Cash is paid when you purchase the building or purchase the assets.

Q. And how much did Frank Lyon put in in all cash? A. $7,640,000.

Q. Of its own money? A. Of its own money.

Q. Without borrowing any? A. No, not without borrowing.

Q. How much did it borrow? A. From First National City Bank we borrowed $7 million. So on November 30 of '69 we had put $7,640,000 in the building. [109] We had borrowed $7 million from First National City Bank and in real estate parlance had an equity of $640,000 in the building.

Q. So in net effect Frank Lyon Company put $500,000 from its own cash from retained earnings into the Worthen Bank Building? A. No, we put $7,640,000.

Q. Of your retained earnings? Not counting borrowings. How much retained earnings did Frank Lyon Company put into the Worthen Bank arrangement? A. I'm not sure exactly how you are using "retained earnings".

Q. Wasn't there a cash expenditure from the company's retained earnings of $500,000, a borrowing from New York Life of $7,140,000 to pay the entire amount of the transaction with Worthen Bank; is that correct? A. Again, we put $7,640,000 in the bank. We did borrow from New York Life $7,140,000. In real estate parlance our equity in the building was $500,000. I don't know how you correlate the exact dollars as far as coming from retained earnings or—

Q. It cost the company in cash out of its earnings $500,000; is that correct? A. No.

Q. What did it cost from the company's earnings to [110] construct the building or pay for the building? A. I'm not sure how you get from net earnings to net assets. I'm not trying to be cute or unresponsive to your question.

Q. A specification sheet, which is Plaintiff's Exhibit 13, there is a statement that the investor is expected to put up $500,000. Is that what Frank Lyon Company put up? A. I assume you're talking about paragraph number one on Plaintiff's Exhibit 13.

Q. That's correct. A. Yes. As I testified, that was the equity.

Q. My question was: The equity came from cash or money that Frank Lyon Company already had and was not from outside borrowings that it put in; is that correct?

The Court: You really asked whether it was from retained earnings.

By Mr. Sayre:

Q. If it came from current expenditures or retained earnings. It was cash that the company had; is that correct? A. Immediately before the New York Life loan was closed, our equity was $640,000.

Q. After the New York Life loan was closed. A. We had borrowed $7,140,000 from New York Life. We had purchased the assets for $7,640,000.

Q. And that left the company putting into the venture [111] $500,000; is that correct? A. As I testified, that is our equity in the investment.

Q. Then it came either from current earnings or retained earnings; is that correct? A. On borrowings or sale of other assets or liquidation of accounts receivable.

Mr. Sayre: Would you make this as Defendant's Exhibit 18.

(The document referred to was marked for identification as Defendant's exhibit 18.)

By Mr. Sayre:

Q. I hand you what's been marked as Defendant's exhibit 18 and ask if you can identify that, please. A. Yes, I can. This is a photostatic copy of the general ledger of Frank Lyon Company at 12-31-69.

Mr. Sayre: Your Honor, I would offer into evidence Defendant's exhibit No. 18.

The Court: Any objection?

Mr. Williamson: That was Defendant's exhibit 18?

Mr. Sayre: Yes, sir.

Mr. Williamson: I thought it had been offered. No objection, Your Honor.

The Court: Defendant's exhibit 18 is received.

(The document previously marked [112] for identification as Defendant's exhibit 18 was received in evidence.)

By Mr. Sayre:

Q. And you say about the time you closed with City Bank—excuse me—closed with New York Life paid off City Bank, that was in— A. On November 30, 1969.

Q. And during August of 1969 did Frank Lyon Company borrow an amount of $500,000 from the Worthen Bank? A. Yes, on August the 21st, 1969, we did.

Q. And that is reflected on the second page of Exhibit 18 as a $500,000 credit? A. That's correct.

Q. It doesn't show any payments made on the loan in the year 1969. Were principal payments made in 1969? A. No, it was a one-year note.

Q. Was it paid at the end of the year? A. No, we asked Worthen to renew it.

Q. Have they renewed it? A. Yes, they have.

Q. And they have renewed it every year since; is that correct? A. Yes.

Q. At the request of Frank Lyon Company? A. At the request of Frank Lyon Company.

[113] Q. Now your other debts as shown on this general ledger sheet, there are payments made on a loan to First National Bank of Little Rock and to accrued life insurance. Also another loan to Worthen Bank on which there are payments of $12,500. May I ask why there's been no payments on this $500,000 loan. A. It depends entirely on the terms of the note. The note you have referred to to the First National Bank and the other note to Worthen Bank were five-year notes requiring quarterly principal reductions of, in the case of Worthen Bank $12,500 a quarter; in the case of First National, $11,875 with a balloon at the end of five years.

Q. So this was a different type of note from the normal note that you entered into? A. Different from those two preceding notes, yes.

Q. This note was made some two months before the closing—two or three months before the closing—and to date there has been no payment of principal on that $500,000? A. That's right.

Q. And the $500,000 is the amount of equity that the Frank Lyon Company had in the building—excuse me, in the Worthen Bank Building as of the date of closing? A. After the permanent loan was closed, yes.

Q. Now if you will look at Plaintiff's exhibit 13, which is the specification sheet—

The Court: Let's don't go by that. Your commitment [114] was made in October of what year?

The Witness: '67 Your Honor.

The Court: All right. Now at what time did anyone in your company to your knowledge become aware of or interested in any possibility in connection with the acquisition of the Coca Cola stock?

The Witness: It was in late July or the first of August of 1969.

The Court: '69?

The Witness: Yes, sir.

The Court: And the acquisition was actually made in '69?

The Witness: It was on August 21st, 1969.

The Court: And you borrowed from Worthen a half million dollars?

The Witness: Correct.

The Court: On a one-year note which has been renewed from time to time thereafter?

The Witness: Yes, Your Honor.

The Court: Now was there any relationship of the Coca Cola acquisition to this transaction?

The Witness: None whatsoever.

The Court: Was there ever any other agreement, hidden or otherwise, or representation by Worthen that back in October of 1967 that, "If you will do this now we are going to be very [115] lenient with you or will provide capital for your future acquisitions," or was there any such understanding at all?

The Witness: Not to my knowledge.

The Court: Let me ask you Mr. Sayre. I want to follow the testimony and be sure I am aware of the significance

of each bit of it that you bring out. What is the Government's position in connection with the half million dollar loan by Worthen which has been renewed from time to time, which apparently was used by plaintiff in connection with the acquisition of the Coca Cola stock. What relationship does that have to this transaction?

Mr. Sayre: May I ask the witness one question to clarify.

By Mr. Sayre:

Q. Has there been any other loans? I believe I asked you to bring records of all loans. Are there any other loans to Worthen outstanding during that period of time other than those shown on the exhibit? A. These were the ones outstanding at that time.

The Court: What exhibit are you referring to?

The Witness: Defendant's Exhibit 18, Your Honor.

By Mr. Sayre:

Q. And has there been any other loan from Worthen Bank that has been deferred in this manner as this $500,000 loan has? A. We have complied with all the terms of each loan. [116] The one to First National Bank and the one to Worthen were originally $500,000 loans. They were five-year loans requiring quarterly reductions of principal. That was not—this was a one-year loan.

Q. Why was this handled differently and why has no payment been made? A. Because the very heavy debt payments we had to make to the ex-stockholders of Coca Cola being paid over a four-year period. We had to pay in principal approximately $600,000 a year to them, plus interest. So we had to pay somewhere between three-quarters of a million and a million dollars to them. At that time we did not want to obligate ourselves to make any fixed reduction of that note, and in talking with the officers of Worthen we thought the best way to handle it was, "They can loan it to us for a year. We will take a

look and see what our cash position is. We may pay it in full or renew it or pay it in part."

The Court: What has been the practice? Just paid the yearly interest?

The Witness: Yes, sir.

The Court: Have the renewals been on the same interest?

The Witness: Prime has gone up since then.

The Court: Is that prime?

The Witness: I think it was a half over prime. I'm sorry, Your Honor. I'm thinking of the other half million [117] dollar note.

No, this one, I believe, because Worthen realized it might be a long-term commitment, I think the interest rate was around nine percent. I think that the prime was around six and three-quarters. So it would have been about two over prime.

By Mr. Sayre:

Q. Mr. Cotham, you said Worthen was aware this might be a long-term. You said that Coca Cola Company is netting $700,000 a year in income and your tax shelter, I believe, was substantial in these years. A Yes.

Q. But you only had to pay $600,000 in payment to the —over actually a three-year period or four-year period. A. Four equal installments of principal.

Q. Of 61 percent? A. Right, the 71 percent.

Q. So what I'm asking you is: Why was this loan handled differently if you had that kind of cash flow than any other loan from Worthen Bank? A. The earnings of the Coca Cola Company have all been retained by that corporation, and they have used those to go ahead and expand the physical plant and for purposes solely related to the Coca Cola Bottling Company.

Q. Is it a wholly-owned subsidiary? A. Wholly-owned subsidiary.

[118] Q. Does it file a consolidated return? A. No, it does not, and there has been no dividend paid. Therefore, we did not have that cash. The only cash that Frank Lyon Company had was from the earnings on the sale of the appliances. This was sheltered by our real estate investments. However, at this time we had note obligations to Worthen Bank on the half million dollar note that was negotiated, I think, in '66, '67 requiring quarterly reductions of $12,500. We had quarterly reductions to First National Bank of $11,875. We had annual installments of approximately $600,000 to the "X" stockholders of the Coca Cola Bottling Company, and we had principal payments of around $300,000 a year to Republic National Bank.

Q. Did Frank Lyon Company, during the years in which this Coca Cola debt was outstanding, have taxable income for federal tax purposes—— A. The Coca Cola Company?

Q. No, Frank Lyon—or did it operate as a loss corporation? A. For 1969 I believe we had a operating loss.

Q. What about the subsequent years? A. I'm not sure. '70 I don't believe that we did.

Q. You don't believe that you did what? A. Did have a net operating loss.

Q. And you have had taxable income since then? [119] A. Yes.

Q. But you haven't used those funds to retire a debt of the corporation? A. We have.

Q. But not this particular debt? A. That's correct, not that particular note.

Mr. Sayre: Your Honor, the purpose of pointing this out is to show the circumstances were at least in a time frame close to the time of the closing of this arrangement with the permanent financing from New York Life and that the loan has been handled in a manner different from any of the loans Frank Lyon has made from Worthen Bank.

These parties were fairly closely related in their negotiations on this building, and I believe it's pertinent to show a different kind of dealing in an amount which is perhaps coincidentally or perhaps purposely the same amount as the equity in which Frank Lyon put into the building.

The Court: I want a little better explanation. It looks as if you look upon it as some sort of a suspicious circumstances, and I want to follow the inferences that are to be derived from that.

Are you suggesting that it is evidence of a hidden agreement or an additional benefit that would accrue to the plaintiff if it entered into the bank arrangement?

Mr. Sayre: Yes, sir, I think, Your Honor, it is an [120] inference of an understanding.

The Court: If, in fact, it was so, how does that strengthen the Government's position? Isn't it one of the problems that they do not charge more in connection with their offer to act as investor in this case than perhaps others or the ones they were negotiating with?

Mr. Sayre: It would show that Worthen Bank, it is the Government's position, is the true economic owner for tax purposes of this building and that in essence they had subsidized the investment of Frank Lyon Company by lending them $500,000 which has not to date had any payment paid on it and is treated differently from any other loan Frank Lyon has now or has had with the same lending institution.

The Court: Well, you mean they had at the time they put up this money, some $500,000—you call it retained earnings.

Mr. Sayre: Frank Lyon had an equity and expenditure of $500,000.

The Court: Now the suggestion is, then, they would not have put that money in or they needed it in their own

business if they did not have some commitment from the bank to replace it, in effect, by a loan in the future.

Mr. Sayre: Your Honor, Mr. Cotham has testified the tax effects or the tax shelter was desired to shelter the income from tax—unrelated or other income of the corporation from the TV appliance sales from taxation.

[121] In this manner they could have invested their $500,000 into the Twin City Bank and put the additional $500,000 that they put into the bank into the Twin City and borrow it.

Instead of that, they chose to buy the tax benefit, that being the depreciation deduction, and then Worthen Bank has made a loan to Frank Lyon Company which is identical in amount to the amount which was handed two months—over this period of time or the net effect of $500,000 put into the building by Frank Lyon Company.

The Court: Mr. Cotham, how about the Twin City investment? Was that opportunity known to any of the officers of the plaintiff or yourself at the time that you made the commitment on this bank building?

The Witness: No, Your Honor, it was not. That only became available when the president of the Twin City Bank, Mr. H. L. Tupp, died and the heirs of his estate decided to liquidate his investment.

The Court: He died when? In '68?

The Witness: I just don't recall the date of his death, but I believe it was in the spring of '68.

The Court: And did that transaction have anything to do with this——

Mr. Sayre: Excuse me, Your Honor. I believe I said Twin City Bank and I believe we are talking about Coca Cola.

The Court: We are talking about both, I guess, if [122] you're looking at both. Mr. Cotham testified the company was doing well and looking to diversify and shows this particular opportunity to look upon it as such and as a consequence of it created the potential acquisition of still others.

But these others, at least one of them some two years later shortly before the closing of the loan, required additional money they had to borrow. If it had some relationship, if it was part of the transaction, a hidden part of it, and if that is what I should be looking for I want to and to follow your theory. But the Court just—I am like you: $500,000, suspicious circumstances. But suspicious of what, and how am I to follow it through and be sure I get your point? From time to time when you are trying it to the Court I'm going to be asking questions to find out why you are asking.

By Mr. Sayre:

Q. With regard to the interest rate, is it still carried at nine percent? A. I believe so, yes.

Q. Which is how much below the prime? A. Well, until the Brock bill was passed we had a 10 percent usury limitation and all our notes to the Arkansas banks had been 10 percent.

Q. And it is still carried below prime? A. Yes. I don't recall the exact rate; between nine and ten percent.

[123] Q. It's your testimony that to your knowledge there was no understanding of Worthen Bank that it would make a loan of $500,000 to Frank Lyon Company about the time of the closing? A. That's correct. There was no understanding.

Q. Now with regard to paragraph one of Exhibit 13 which is b under specification, "equity to be supplied by investor, $500,000, and annual rate of interest to be charged thereon, six percent." That's couched in terms of a debt. You pay interest on a debt obligation.

It's the Government's position in this case that in substance for tax purposes Frank Lyon Company made a loan to the Worthen Bank of $500,000. May I ask why or how it was calculated that six percent would be returned on that money and also how in Exhibit 14 the Frank Lyon Company acknowledged that there would be six percent on the second page? A. To answer your first question, the sale and leaseback was directed by the officers of Worthen Bank. I don't know why they phrased it that way.

In response to your second question, we quote virtually verbatim their specification for sale and leaseback they had handed us approximately two days earlier without alteration except for an offer of the $21,000 that we mentioned in paragraph two of the lessor.

Q. With regard to that $21,000 actually you said you made that as an inducement. The actual terms of the agreement [124] between Frank Lyon Company and Worthen Bank do not reflect that $21,000 saving, do they? A. That's correct, they do not.

Q. They go back to an amount in excess of $571,000—$583,000. A. What five eighty-three?

Q. Instead of $142,000, it's a little over $143,000; is that correct? A. I don't recall off-hand without referring to the note. Whatever the note says is correct.

Q. Well—— A. What exhibit is that?

Q. Look at your debt service, which is Defendant's exhibit No. 7, and it will show you the amortization schedule. I think the note is probably Exhibit No. 26 or 27. A. Right.

Yes, it does require quarterly installments of $145,581.03.

Q. So there was no saving of $21,000 by the bank by agreeing to Frank Lyon's proposal—— A. Correct.

Q. —for accepting Frank Lyon's counter proposal. A. Correct.

Q. Now you stated you made these calculations and one of the intentions was to shelter income by use of the double [125] declining balance method of depreciation. A. That's correct.

Q. Now was it also one of the considerations that at that time Section 1250 of the Internal Revenue Code provided for recapture on accelerated depreciation of buildings? If a building was held longer than 10 years there would be no recapture. A. I was aware of that provision, yes.

Q. So the first option date being 11 years would mean if the transaction stood without being questioned that capital gain would be realized on the entire amount of the exercise of the option price, if exercised? A. Correct, but the option periods were dictated by Worthen.

Q. You were aware of the fact? A. I was aware of the facts, yes.

Q. May I ask why—you said 11 years is the maximum shelter that can be achieved. A. Yes.

Q. Then it starts to go back the other way? A. Yes.

Q. May I ask why the rental payments were designed to change at 11 years and increase and did increase some $8,000? A. This was part of the package that Worthen Bank had offered to us, Plaintiff's Exhibit 13.

[126] Q. I believe these figures were not used. The other figures were used. In your note you read a moment ago, $145,000 and $153,000 were actually used. Why did Frank Lyon Company agree to the increase in rent after the end of 11 years? A. The rental income and the debt service were to be approximately equal.

Q. They weren't to be approximately equal; they were to be exactly equal; is that correct? A. They were equal.

Q. To the penny? A. To the penny—for the first 25 years.

Q. Now going back to Exhibit No. 13, Worthen Bank had contracted—had already broken ground in September of 1967 on the construction of the property; is that correct? A. Yes.

Q. And Defendant's Exhibit—I don't remember the number right off, but the contracts between the architect and the bank, between the overseeing consulting engineer and the bank, and between the construction company and the bank were all in effect prior to the time that Frank

Lyon came into this arrangement; is that correct? A. That is correct.

Q. And during the entire period of construction of the bank after Frank Lyon Company came into the picture in May of 1969, the bank continued to oversee the operation at the site [127] and the actual construction of the bank? A. That is correct.

Q. You did not assume any obligation under the contracts with these building architectural entities? A. Not with the architect nor with the contractor, that's correct.

Q. And one of the reasons was because Worthen Bank wanted to save approximately $125,000 in sales tax that it could save as the builder of the building; is that correct? A. That's what one officer told me, yes.

Q. If you, being Frank Lyon Company, had purchased the building or, in effect, you really didn't purchase a building as such; it was under construction at that time and you said you purchased a little bit as it went up; is that correct? A. That's correct.

Q. If Frank Lyon Company had built the building and leased it back, the amount of sales tax would have been added into the cost; is that correct? A. Yes.

Q. So there was a savings to Worthen Bank of $125,000 by doing it in this manner; is that right? A. That's correct.

Q. Under Exhibit 13, one of the requirements was that all investment credit and sales tax savings with regard to the construction of this building be passed through to Worthen Bank; [128] and it was, in fact, passed through? A. Yes, it was.

Q. So all investment credit on the building itself or the equipment in the building went to Worthen Bank rather than Frank Lyon Company? A. Yes.

Q. And prior to Frank Lyon Company getting into this arrangement, there had been numerous trips by Worthen Bank to New York to visit with First National City Bank and also with New York Life, and they had commitments

for interim and permanent financing before Frank Lyon Company came into the picture; is that correct? A. I have no knowledge about any trips they took. I do know they had made initial contacts.

Q. And they had commitments on the financing subject to finding an acceptable investor? A. Subject to the lendor's—yes, approving the borrower.

Q. Now this exhibit says that the interim financing is to be supplied by City National Bank of New York at prime rate, such interest to be paid by Worthen on amounts actually disbursed.

The Court: Where are you reading from?

Mr. Sayre: The next to last paragraph before the numbers, Your Honor.

The Court: In which document?

Mr. Sayre: Exhibit 13.

[129] The Court: Oh, I see.

Mr. Sayre: There's a series of numbered paragraphs, and it was the one before.

The Court: All right.

By Mr. Sayre:

Q. Now under the proposal of Worthen Bank they would pay the interim financing interest charge; is that correct? A. That's apparently what the specification of the sale and leaseback provides, yes.

Q. And did they pay the amount? A. No, sir, they did not. Frank Lyon Company paid the interest.

Q. Frank Lyon Company paid interest and fees to accountants and to attorneys of approximately $500,000 in connection with the construction of this building; is that correct? A. Yes, between $450,000 and $500,000, yes.

Q. And you cannot tell the Court why the specifications state that the investor would put in $500,000 at an annual rate of interest of six percent or why the company acknowledged that in its agreement? A. We acknowledged it because we were just trying to repeat verbatim the specifications for the sale and leaseback they handed us.

Q. On your calculations have you made calculations to show what the tax position of Frank Lyon Company would be if [130] the options were exercised? A. Yes, we did.

Q. It would be, at the end of 11 years, approximately $300,000 in gain; is that correct? A. On the sale there would be about—I think it was about three and a half million dollar gain on the sale.

The Court: Apparently there were considerable negotiations after the specification and letter——

The Witness: Yes, Your Honor, there were.

The Court: —in which additional terms were agreed upon which were reflected by the documents; is that correct?

The Witness: That is correct.

By Mr. Sayre:

Q. Now with regard to the construction, you said the Worthen Bank oversaw the complete construction. I take it the mechanics would be that on a monthly basis demand would be made by the contractor—the general contractor to Worthen Bank for payment, and Worthen Bank would then make demand upon you to pull down amounts from City Bank under the financing agreement, and you would reimburse Worthen Bank for their payment to the contractor. A. We would not reimburse Worthen. We actually paid the contractor.

Q. In other words, Worthen paid all the bills for the construction of the bank and you drew the money from City Bank [131] and paid it to Worthen? A. Yes. We reimbursed Worthen.

Q. Frank Lyon Company did not have anyone to oversee the construction of the building? A. That's correct.

Q. Now you said that with regard to this rental, it's equal to the penny to the debt service owed to New York Life? A. That's correct.

Q. And there is, then, no hope of making a cash flow or an economic profit off this arrangement for the first 25 years; is that correct? A. From a cash standpoint for the first 25 years that's correct, outside of the income tax consideration; but from 25 to 75 there would be.

Q. But in the original 25 year term which the bank has four options to repurchase, there is no way that a cash profit or cash flow can be made by Frank Lyon Company? A. That's right. Our economic profit comes from increasing the equity in the building.

Q. Now the equity, you say, in the building—the amount of the option price of Worthen Bank in the building lease—decreases instead of increases; is that correct? A. That's correct.

Q. So that if the building increased in value or appreciated in value or stayed the same and had a market value of [132] seven and a half or $9 million, or whatever that value of the total investment in the building was, that at the end of the 25-year term any appreciation that would be in that building could be taken away from Frank Lyon Company by the Worthen Bank's exercise of the option for the stated option price? A. They would purchase the building for the stated option price.

Q. And, therefore, there would be no equity or appreciated value to Frank Lyon. It would be taken away by the exercise of the option? A. We would have sold it for approximately two plus million dollars at the end of the twenty-fifth year.

Q. We are assuming that the value of the building stays between 7 and $9 million. A. I'm not sure that's a valid assumption. Buildings would deteriorate.

Q. Then it's your assumption that the market value of the building would be only $2 million in 19—or after 25 years? A. Perhaps, yes.

Q. Now with regard to the term of the rental under the building lease, Frank Lyon Company at the end of 25 years

would be receiving in excess of $600,000 a year; is that correct? A. At the end of which period, sir?

Q. At the end of 25 years. A. At the end of 25 years?

[133] Q. You were going into what you were going to get after 25 years, and that's all assuming that no option is exercised by the bank. A. That's correct. Our original proposal was we would receive $600,000 a year.

Q. What I'm asking is: Why would Frank Lyon Company be willing to cut its rent in half? If $600,000 would be the fair rental value in 1994, then the next year why would they be willing to take half and the net amount greatly reduce some over that period? A. Half a loaf is better than no loaf. It looked like other investors against whom we were competing were willing to do it for less, according to the terms of the Specification of Sale and Leaseback. So the $300,000 rent was just out of the question. We did have to settle for a smaller amount of rent.

Q. The ground lease on the building site was for $50 for the initial 25-year term? A. That's correct.

Q. And that, you explained, was because of a net effect but that was not the fair rental value of that property. A. No, it was not.

The Court: Mr. Sayre, let me interupt you to give the court reporter a break. We will be in recess for 15 minutes.

[134] The Court: Mr. Sayre, you may continue.

By Mr .Sayre:

Q. Going back again to the depreciation deduction, that is not an actual cash expenditure or cash expense. It is a bookkeeping entry; is that correct? A. The cash disbursement has been made when the asset was purchased.

Q. And that's where we came into this $500,000 versus $7,640,000.

Now Worthen Bank paid to Frank Lyon Company an amount identically equal to the debt service so that the money Frank Lyon received from Worthen Bank was then

turned over to New York Life and paid off principal and interest payment; is that correct? A. The rent check goes into our regular bank account and we do write a check in the same amount to New York Life to pay our debt.

Q. There's no yearly expenditure for depreciation. It is a bookkeeping entry theoretically to recover costs of amounts expended. A. It's a non-cash expense in that year.

Q. And the cash expenditure that Frank Lyon Company made was $500,000 in equity, and then for bookkeeping purposes or for tax purposes, or however it's accounted for on your books, amounts were received as rental, credit as rental, and [135] deduction taken; is that correct? A. Which $500,000 are you referring to?

Q. The original $500,000 in equity put into the—— A. Again, we purchased the building for $7,640,000. On that investment we are receiving rentals of around $580,000 a year.

Q. For tax benefit purposes, a cash expenditure was made from Frank Lyon Company's own funds of $500,000? A. That was our equity in the building.

Q. And an asset was acquired with a basis of $7,640,000 which was depreciated then by Frank Lyon Company? A. Yes. They are the owners of the building.

Q. And what is the depreciation deduction in the first full year of 1970? A. It's about $614,000.

Q. And the interest payment was how much? A. In the first year it was $478,000.

Q. So about a million dollars? A. Total deduction in the first year, yes.

Q. A million dollar deduction on a $500,000 cash expenditure from funds? A. Rental income of about $582,000 in that year.

Q. Excuse me. Then there was a net amount of $400,000? A. Approximately.

Q. Again you say that Frank Lyon Company bought a building. [136] The building was not completed. It was in

the process of being constructed. It had already been started by Worthen Bank. A. That's correct.

Q. And they paid for all the expenditures for the land, the parking garage, and the initial million or million and a half dollars in expenditures for the building before Frank Lyon came into the picture; is that correct? A. That's correct.

Q. So actually would you say the basement belongs to Worthen and you own the rest of it? A. No. We own the building.

Q. Now on Exhibit 13 on the options on the second page, how were the amounts determined of 822, a million, a million-six, and two million one hundred forty-five? A. I don't know. This was prepared by Worthen Bank.

Q. Eventually the amounts that were agreed upon were couched in terms not of an assumption plus this amount but an assumption—excuse me, a total dollar figure; is that correct? A. Yes, that's correct.

Q. I believe paragraph 21 or something of Exhibit 19 is the option.

Now there is a discount factor of $198,280 shown on the fifteenth year. Was that carried over into the agreement? A. I don't recall specifically, but I assume it was.

Q. What does that discount represent? [137] A. I don't know.

The Court: What are you talking about?

Mr. Sayre: The second page, Your Honor——

The Court: I have it.

Mr. Sayre: —where it shows the $1,198,280 minus $198,280.

The Court: In parenthesis.

By Mr .Sayre:

Q. What is the discount determined, and if it was carried over what does it represent? A. It looks like it was just

an amount to round the fifteenth year off to a million dollars—the figure that was backed into—but that is just a speculation on my part. As I said, I did not prepare this specification.

The Court: Do you know what the figures are in the parenthesis: the eleventh year or fifteenth year?

The Witness: No, Your Honor, I do not.

The Court: All right.

The Witness: The one for the fifteenth year apparently ties into paragraph six. The amounts are the same as "B" and "C".

By Mr .Sayre:

Q. Let me ask you. On Exhibit 14 you show a repurchase after the eleventh year. Now you prepared this exihibit? A. Exhibit 14, yes.

[138] Q. Second page. What is the discount of $149,000 there representing? A. We were again copying verbatim the form they had given us, and it's just an amount to round off—it looks like the equity to $800,000.

Q. Let's go back to—do you have the knowledge if this figure of $822,000 or approximately $800,000 as shown on your computation, Exhibit 14, was the amount of the net amount received not on the assumption but the net amount to be received under the final agreement? A. I assume it was. We could tie it out by taking a look at the amortization schedule by taking a look to see what the outstanding balance of the mortgage would be.

Q. That's Defendant's Exhibit 7. A. Yes, sir, that's approximately the figure. You're Defendant's Exhibit 7 shows that the outstanding balance of the debt is $5,521,000 at that time, and the option price in section 20.1 of the building lease is $6,325,000, approximately, so that would be $804,000 cash.

Q. That would be the amount of net equity again or net equity realized by Frank Lyon out of the transaction; is

that correct? A. That would be the cash that we would receive on the sale. They would assume the mortgage and give us that much in cash.

[139] The cash put in by Frank Lyon was originally $500,000 is that correct? A. The equity in the building, yes, was $500,000.

Q. So there would be an increase to Frank Lyon Company of a little in excess of $300,000 in cash if the option were exercised at the end of 11 years? A. Yes.

Q. Now was this calculated prior to the time the instruments were entered into? A. I'm sure it was.

Q. Does that amount represent approximately six percent interest as referred to in your Exhibit 14, which is your acceptance, and the bank's Exhibit 13, which is their specifications? A. Let's see. Purchased the building for $7,640,000 and borrowed seventeen-forty from New York Life, so our equity was a half million dollars. Three hundred forty divided by a half million is about 60 plus percent, so divided by 11—plus or minus six percent, roughly.

The Court: In other words, the least benefit that Frank Lyon could make would be, in effect, a six percent on its money, plus the tax benefit which would accrue during the period of this time?

The Witness: Yes, Your Honor, if Worthen exercised their option at that time.

[140] The Court: Under any other set of facts they would receive more benefits?

The Witness: Yes, Your Honor.

By Mr. Sayre:

Q. You said that these two entities that Frank Lyon Company invested in: Twin City Bank and the Coca Cola Company, were both money makers or profitable corporations? A. Yes. But no dividend has been paid by either one to Frank Lyon Company.

Q. But they were viable; profitable corporations that were acquired by Frank Lyon? A. Yes.

Q. At one time did Frank Lyon Company own or have a subsidiary that owned a Gibson's discount store? A. Yes.

Q. Was it a profitable venture? A. It was for awhile.

Q. And then became a loosing venture? A. Less than acceptable return.

Q. And it was disposed of? A. We sold it, yes, to the Jasper Howard Group who had a larger chain of discount stores.

Q. Now the Worthen Bank transaction was not profitable during the initial 25-year term of the lease to the Frank Lyon Company; is that correct? [141] A. No, that's a correct [sic] statement. It was profitable.

Q. During the first 25-year period? A. During the first 25 years.

Q. How was it profitable? A. Because with every principal payment on the debt service, we were reducing the amount we owed on the mortgage and thereby increasing our equity in the building.

Q. You said one of the reasons that Frank Lyon Company wanted to get this was to build up an equity in the building. Again, you admitted that if Worthen Bank exercises its option, Frank Lyon Company would lose the equity. A. We would sell it to Worthen.

Q. Under the agreement you would have to sell for the stated price. A. That's right.

Q. You have no equity. A. But we would realize a gain on the sale.

Q. Excuse me. You would realize a gain on the sale? A. Yes. I thought you just asked me to compute that it was around six percent.

Q. About six percent gain on the sale? A. That would be per year on an annualized rate. It's really about 60 percent on the equity at the end of the eleventh year.

Q. You said it would be mutually profitable to both [142] entities—both Worthen Bank and Frank Lyon—to enter

into such an arrangement is one of the reasons. Was that the fact that you were told you would get this loan of $500,000 or favorable treatment on similar loans? A. No. As I pointed out, one of the reasons I was anxious to enter into it was I hoped it would strengthen our relationship with Worthen Bank.

Q. You said it would be profitable in as much as the double declining balance depreciation deduction would give you a cash savings of about a million and a half dollars in the first 11 years. A. That's correct. It would shelter about $3 million in income and would save taxes totaling a million and a half.

Q. And all of these speculations about what would happen after 25 years and after 65 years and after 75 years would not ever come about if Worthen Bank exercises the option to purchase; is that correct—exercises the option to purchase or repurchase? A. Speculating on whether they would or would not exercise the option, it may or may not come about.

Q. We are assuming if they exercise the option all that is wiped out. A. If they don't, it's very real.

Q. You stated in the other transaction regarding subsidiary corporations, I believe, of Frank Lyon Company are real estate corporations. Are they subsidiaries of Frank Lyon? [143] A. No, they are not.

Q. Are they real estate corporations owning property or stores in which subsidiaries have their operations. A. Some of them are, yes.

Q. And there is a small cash flow on these? A. Minimal cash flow.

The Court: Let me interupt a minute. I haven't looked at the witness list. Are we going to have any experts on sale and leaseback agreements here to testify?

Mr. Williamson: Yes, Your Honor.

The Court: All right.

Mr. Sayre: Your Honor, I think I have reached a point if you would like to take Mr. Dover out of sequence at this time, it would be all right.

The Court: It is your pleasure, gentlemen. I can do it any way you wish.

Why don't you stand down, Mr. Cotham.

(Witness excused.)

The Court: Mr. Dover, come forward, raise your right hand, and be sworn.

Darrell Dover

having been called as a witness by and on behalf of Plaintiff, and having been first duly sworn, was examined and testified as follows:

Thereupon,

[144] DIRECT EXAMINATION

By Mr. Giroir:

Q. State your name for the record, please. A. Darrell Dover.

Q. What is your residence address? A. 22 River Valley.

Q. What is your occupation? A. Attorney.

Q. With whom are you associated in the practice of law? A. House, Holmes and Jewell.

Q. That's a law firm here in Little Rock, Arkansas? A. Correct, sir.

Q. Did your firm serve as counsel to New York Life Insurance Company in connection with a permanent loan to Frank Lyon Company to purchase the building? A. Yes.

Q. When were you employed? A. '67. Late '67 or early '68.

Q. Do you recall whether or not a written commitment had been issued to Frank Lyon Company by New York Life at that time? A. Yes, sir, it had been.

Q. Are you personally familiar with any of the negotiations or background leading up to the issuance of that letter? A. No, sir.

[145] Q. Who was your primary contact or whom did you associate with in New York Life Insurance? A. Mr. Smith, Charlie Smith, assistant—I believe he's assistant chief counsel for New York Life.

Q. Did you consider him to be knowledgable in real estate lending matters? A. Very.

Q. Was he active in connection with structuring of the transactions? A. Yes, sir. Yes, sir. He played a large part.

Q. In your dealings with the lendor or with the borrower, Frank Lyon Company, with whom did you have contact? A. Yourself and Mr. Cotham.

Q. In your dealings with the interim lendor, First National City Bank, with whom did you have contact? A. Mr. Dirkey with a New York law firm.

Q. With Worthen Bank with whom did you have contact? A. Mr. Dick Williams of the law firm——

The Court: Wright, Lindsey and Jennings.

The Witness: Excuse me, Your Honor.

By Mr. Giroir:

Q. Did the negotiations extend over an extensive period of time? A. Yes, sir, they did. Awhile ago I said I was employed in either late 1967 or early 1968. The negotiations continued [146] for approximately [illegible] to six months.

Q. What took so long? A. Well, there was just considerable give and take, bargaining, negotiating between parties. I assume these documents are in evidence. There were volumes of documents and they were negotiated chapter and verse, paragraph by paragraph, almost word for word.

Q. How would you characterize the negotiations between the four parties? Were they serious negotiations? A. Certainly. Certainly very serious.

Q. Were important terms of each of the documents the subject of conferences and discussions? A. Yes, sir. Yes,

sir. As I say, it was virtually a paragraph by paragraph, provision by provision negotiation.

Q. Now in some instances did all the parties participate in the negotiations? A. Yes, sir.

Q. In all instances did all parties participate in the negotiations? A. I have searched my recollection. I think there were certain instances where simply New York Life and the Lyon Company were represented. Just the two parties: lendor and borrower.

Q. Were any of those instances where New York Life Insurance Company and Frank Lyon representatives were involved [147] in the negotiating, were any of those conducted out of town? A. Yes, sir. My memory is that there was a trip to New York at which one of those conferences took place.

Q. Were there instances where negotiations were conducted only by Worthen and Lyon but perhaps in your presence? A. Conversations, yes, sir. Discussions.

Q. What was your interest in the lease agreement between Worthen and Frank Lyon? A. Well, the lease agreement is a major part of the security for the loan. As I recall the transaction, it is structured so that the lease would survive the foreclosure by New York Life and we'd be looking to Worthen Bank and Trust Company as the leasee.

Q. Was there any guarantee by Worthen Bank of Frank Lyon's note to New York Life? A. No, sir.

Q. To whom did New York Life look as the borrower and primary obligor on the note? A. The maker, Frank Lyon Company.

Q. If there was a default by Frank Lyon Company and New York Life elected to accelerate the obligation of Frank Lyon Company, did that also trigger an acceleration or otherwise disturb Worthen Bank's lease? A. No, sir. No, sir. As I say, it was structured—this is from memory but I think it's accurate—it was [148] structured so the lease would survive an acceleration or foreclosure or what have you.

Q. So in the event that Frank Lyon defaulted you could be conceivably in litigation with Frank Lyon while at the same time Worthen Bank went along unaffected. A. Correct.

Q. Conversely, if Worthen Bank defaulted on the lease, did that trigger a default on the note? A. No, sir. No, not legally. Practically it probably could have if that resulted in the Lyon Company not having the funds with which to pay New York Life.

Q. But that second step would have to occur? A. That would have to occur. Legally it was not so structured.

Q. I take it, then, your employment, at least in part, was to give New York Life the opinion that Frank Lyon had a full face and credit obligation to pay $7,140,000 to New York Life.

Mr. Sayre: Your Honor, I object to the leading nature of the question. It is assuming.

The Court: Please don't lead the witness.

By Mr. Giroir:

Q. What was the purpose of your employment? A. It was to render an approving opinion to the New York Life Insurance Company, assuring them that it had a valid [149] and enforceable obligation of the Lyon Company.

Q. Were you employed to give an opinion as to whether or not Worthen Bank had an obligation under the note? A. No, sir. I previously testified it had no such obligation.

The Court: Do you know if your client was concerned with or took an interest in the net worth of the plaintiff and its financial reliability?

The Witness: Your Honor——

The Court: That is, the Frank Lyon Company.

The Witness: I'm new to this proceeding. The plaintiff is Frank Lyon Company?

By Mr. Giroir:

Q. The plaintiff is Frank Lyon Company. A. Yes, sir. Yes, sir. We were furnished either four or five years financial statements of the Lyon Company.

Q. Insofar as you were concerned, do the documents reflect the intention of the parties? A. Yes, sir. I have our firm signatures on the opinion to that effect.

The Court: Particularly, did the documents carry out the instructions as to those intentions given to you by your client?

The Witness: Yes, Your Honor.

The Court: All right. Anything else?

[150] Mr. Giroir: No further questions.

The Court: You may cross examine.

CROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Dover, was the New York Life Insurance Company also interested in the financial wellbeing and net worth of the major tenant or the tenant of the building, the Worthen Bank. A. Surely.

Q. And, in fact, New York Life requires that a yearly financial statement be submitted by Worthen Bank to New York Life with regard to this note purchase; is that correct? A. I think that's correct.

Q. The arrangement for the financing with New York Life, the permanent financing and the construction of the Worthen Bank Building was arranged by the Worthen Bank intially? A. I have been so told.

Q. You said——

The Court: Do you know if the tentative arrangement that had been worked out between Worthen and New York Life were entirely conditional and particularly were they

conditional upon an investor who was satisfactory to your client, or do you know if that was a matter of importance or not discussed or——

The Witness: Judge, that predated my connection with the case. I feel sure that—this is sort of speculation, but I feel, yes, sir, the New York Life would have—the investor [151] would have had to be satisfactory to New York Life.

The Court: Were there any binding contractual agreements binding your client as a result of its associations with Worthen prior to the time that Frank Lyon Company entered the picture that you know of?

The Witness: No, sir. No, sir. But I have no real knowledge of that.

The Court: I'm sorry.

The Witness: I have no real knowledge of what predated my connection with the case.

The Court: I understand. Of course, you had to take it as it was given to you.

The Witness: Our firm was purely special counsel. My understanding was that it had a conditional commitment subject to satisfactory documentation, proof of title.

The Court: When you entered the picture they had already had negotiations with Frank Lyon?

The Witness: Correct, sir.

The Court: And you were more or less called upon to carry out those terms and those formally expressed items?

The Witness: Yes, sir. Yes, sir.

By Mr. Sayre:

Q. In fact, Mr. Dover, weren't you brought in as the representative to represent New York Life because prior to the time they had been represented by the Rose law firm

which was [152] representing Frank Lyon in this matter? Was New York Life a client of the Rose firm? A. Yes, sir.

Q. So to avoid a conflict of interest the House, Holmes and Jewell firm was brought in? A. As special counsel.

Q. And the firm of Wright, Lindsey and Jennings was brought in as special counsel for Worthen rather than the Rose firm that had been used by the Worthen Bank; is that correct? A. I'm so told.

Q. Now New York Life demanded or requested or wanted to acquire or achieve the purpose of having Worthen Bank pledge its assets: the land, the parking garage, as additional security on the deed of trust; is that correct? A. Yes, sir.

Q. And if there was a default you would look to take the deed of trust and turn it into or foreclose on the deed of trust; is that correct? A. That was a possibility I imagine.

Q. You were the trustee and hold this deed of trust or you are the trustee at this time? A. Yes, sir. Yes, sir.

Q. Now the steps of this transaction—by that I mean the guarantees of Worthen Bank to Frank Lyon Company and Frank Lyon Company's guarantees to New York Life in the note and the [153] deed of trust and in the building lease—are similar. In other words, the obligations of Frank Lyon Company to New York are similar to the obligations of Worthen Bank to the Frank Lyon Company; is that correct? A. Your reference to guarantees has confused me because we hold no guarantees.

Q. I refer to the terms of payment. They are identical; is that correct? The rental payments are identical to the debt service? A. Yes, sir, I believe that to be correct.

Q. And Worthen Bank has guaranteed to make the payments to Frank Lyon Company under the rental agreement or the lease. Even if the building is damaged or destroyed they have a guaranteed obligation to pay the rentals for 25 years; is that correct? A. I feel sure that's correct. That is a particular instance where there were substantial

negotiations: the damage to constructions clauses and the condemnation clauses of the various instruments. But, yes, sir, I think the answer to your questions is yes.

Q. And if the building is destroyed or damaged the option—the bank can use the proceeds to pay what is referred to as the assigned, which is New York Life, the assignee. All the rights under the ground lease and under the building lease were assigned to New York Life by both Frank Lyon and the Worthen Bank; is that correct? [154] A. Would you repeat that? If the question is: Was there an agreement, yes, sir.

Q. There was an assignment of all rights by both Frank Lyon and Worthen Bank under the ground lease and the building lease to New York Life? A. That's correct. Everybody assigned everything to New York Life.

Q. Did New York Life look to the viability—the economic viability of Worthen Bank in entering into this arrangement? A. Well, yes, sir, any lendor looks to the validity of a major tenant of its major security.

Q. You said everything was assigned to New York Life. New York Life then dictated a lot of the terms that would go into this arrangement? A. I'd hate to say "dictated".

Q. If there was a dispute you had the last word in a lot of instances? A. Usually our wishes were exceeded to.

Mr. Sayre: No further questions, Your Honor.

The Court: It's getting a little clearer. This Charles Smith——

The Witness: Yes.

The Court: —he is a specialist in this type of business? Is he or is he not?

The Witness: Judge, he's an assistant—at that [155] time he was assistant chief counsel for New York Life Insurance Company, I believe, of its property division and he had all the earmarks of a specialist. I don't know much of his background.

The Court: Did the other attorneys take their lead from him in terms of the structure? Who contributed most to the format: the identification of the number and types of agreements that would be used to consummate the transaction? Who took the leadership in getting the agreements together?

The Witness: Judge, I think Mr. Smith resolved disputes. Actually, the initiation of documentation was here in Little Rock between Mr. Giroir and Mr. Williamson and myself.

If we reached a hangup or impasse we couldn't resolve locally, we'd call Mr. Smith, or on occasions went to New York for conferences in New York.

The Court: All right.

REDIRECT EXAMINATION

By Mr. Giroir:

Q. Just one question. Is there anything in these documents which you find as a lendor's attorney would be unusual in a long-term loan secured by a long-term lease? A. No, sir. They were fairly standard documents.

Mr. Giroir: Thank you.

The Court: Anything else? May Mr. Dover be excused?

You may stand down and you may go as far as the Court is concerned.

[156] (Witness excused.)

The Court: We will resume with the cross examination of Mr. Cotham by Mr. Sayre.

Thereupon,

Ralph R. Cotham, Jr.

having been recalled as a witness by plaintiff, and having been previously duly sworn was further examined and testified as follows:

The Court: Let me ask you. Was this agreement and the structure of it presented to your board of directors at some time before it was reduced to a formal agreement?

The Witness: Your Honor, it was presented to the executive committee and I would make oral reports to the board of directors on it. I did not get into the legal technicalities in detail because, frankly, I didn't think I had the ability to articulate it.

The Court: Well, I was thinking more in terms of the practical effect in terms of the economics of it.

The Witness: Yes, I did do that.

The Court: Explain whether this would be a good deal for Frank Lyon?

The Witness: Yes, Your Honor, I did do that.

The Court: What you could make under the worst circumstances and what you might make under the most advantageous circumstances?

[157] The Witness: Yes, Your Honor.

The Court: Such an explanation was made?

The Witness: It was.

The Court: Before an agreement was entered into?

The Witness: Before an agreement was entered into, both the executive committee—probably in more detail to the executive committee and a general report to the board of directors.

By Mr. Sayre:

Q. With reference to that point, who owns the majority of Frank Lyon Company stock? A. The Lyon Family. Mr. Frank Lyon.

Q. How much stock does Mr. Lyon own—he or his immediate family? A. Mr. Lyon and Mrs. Lyon own right at 45 percent each.

Q. So about 90 percent total? A. Ninety plus, yes.

The Court: I am sure it is in here, but I have not read all these documents and I am going to pay attention to the ones you bring to my attention. When I saw what a formidable task it was when I started reading some of the fine print, I decided I would wait until you told me what was important and what was not.

Let me ask and maybe anticipate. There were balance-sheets submitted to the New York Life and First City National?

The Witness: Yes, Your Honor.

[158] The Court: And at approximately the time the commitment was made—let's put it this way: When the agreements were signed carrying out this, what was the net worth of Frank Lyon Company? Do you know?

The Witness: Between $3 and $4 million.

The Court: The net worth?

The Witness: Yes. As a matter of fact, I believe it's in the stipulation.

Mr. Sayre: Exhibit 34, I believe.

The Court: Let me see if I can find it here.

The Witness: Plaintiff's Exhibit 33, Your Honor.

The Court: As of December 31?

The Witness: As of December 31, 1968, our net worth was $3.8 million.

The Court: And did you submit profit and loss statements, too?

The Witness. Yes, Your Honor.

The Court: Are they following along?

The Witness: Plaintiff's Exhibit 34.

The Court: Very well.

By Mr. Sayre:

Q. Mr. Cotham, Exhibit No. 23, Plaintiff's Exhibit 23 is an assignment, I believe—excuse me, the building loan and mortgage. In that mortgage the Worthen Bank joined with Frank Lyon Company in assigning certain assets to First National City [159] Bank to achieve the interim financing.

The Witness: Yes, they did.

The Court: Now you are referring to which instrument?

The Witness: Plaintiff's Exhibit 23, Your Honor.

The Court: The building loan mortgage?

The Witness: The building loan mortgage.

By Mr. Sayre:

Q. And under Exhibit No. 24, Plaintiff's Exhibit No. 24, the Frank Lyon Company assigned all of its rights under the lease and under the ground lease to First National City Bank; is that correct?

The Witness: That's correct, as security for our loan.

Q. Now Mr. Giroir brought your attention to Exhibit 21, which is the building loan agreement, and that agreement evidences the agreement or arrangement between Frank Lyon Company and the First National City Bank? A. That is correct.

Q. And there are certain obligations. One is that Frank Lyon Company makes in that, beginning with paragraph 8,

I believe, that Frank Lyon shall furnish and cause to be furnished to the lendor on or before making final advance a certificate that the building was completed as required.

Number 9, that the borrower shall furnish or cause to be furnished or the lendor may procure at the expense of [160] borrower surveys.

Paragraphs 8, 9, 10, 11, 12, and 15 require the Frank Lyon Company to make certain agreements or certain warranties—let's see what it is actually titled—certain warranties to First National City Bank. Now if you will flip over to Exhibit No. 25, the sales agreement, this is the agreement that was executed approximately five days after the building loan agreement. This was an agreement between Worthen Bank and Frank Lyon Company.

If you will, begin at paragraph 3 under the covenants at page 7. All of the covenants that Frank Lyon Company has made to the City Bank under paragraphs 8, 9, 10, 11, 12, and 15 of Exhibit 21 are expressly warranted by Worthen Bank to Frank Lyon Company under paragraph 3(b), (c), (d), (e), (f), and (g); is that correct? A. I really do not remember without sitting down and reading them right now.

Q. I have read these documents and—in other words, these same agreements that Frank Lyon Company has made to First National City Bank are assumed by the Worthen Bank, the entity then constructing the building. Worthen Bank also was the entity that arranged with City Bank for the interim financing; is that correct? A. They made the initial contact. We negotiated with City Bank.

[161] Q. With regard to the Exhibit 13 it said the interim financing would be provided by First National City Bank and you were informed that permanent financing was also to be paid by New York Life; is that correct? A. Yes.

Q. Now Exhibit 25, paragraph 3(j) on page 8 states that the bank agrees to indemnify and save the company—Frank Lyon Company—harmless against and from any and

all claims by or on behalf of any person or persons, firm or firms, or corporation or corporations arising out of the failure to deliver the completed bank building to the company on or before the closing date, whether or not the bank is at fault in connection with such failure and unless the failure is a result of act or omission of the company, Frank Lyon.

By that provision, then, the Worthen Bank assumes all responsibility and agrees to indemnify Frank Lyon Company of any loss if any occurred on a failure to complete the building; is that correct? A. Sir, it does not relieve Frank Lyon Company from its responsibility. The clause here is a standard indemnity hold harmless clause.

Q. So, in any case, Worthen Bank was bearing the ultimate risk on construction of the building and the delivery of the building or the sale of the building rather than Frank Lyon Company? [162] A. As it says, they did agree to indemnify and hold us harmless. Rather standard clause in real estate transactions.

Q. And under paragraph 5 of that exhibit there is a default by the bank. "Prior to the closing date, the company at its option may require the bank to repurchase the bank building for an amount equivalent to the sum of all reimbursements paid to the bank under paragraph 2(b) plus all expenses incurred by the company"—Frank Lyon—"under paragraph 6, plus interest thereon at the rate of 10 percent per annum."

In other words, if the bank defaulted, not only were they going to hold you harmless but they were going to buy the building back and pay 10 percent interest on the money you had advanced; is that correct? A. At our option if they defaulted.

The Court: Prior to the closing date?

By Mr. Sayre:

Q. Prior to the closing date? And that date was November 30, 1969. A. Yes.

Q. So the risk, again, during the period of the construction was born by the Worthen Bank rather than the Frank Lyon Company? A. We were on the line too. We did have indemnity agreements an hold harmless agreements and an option or rights we ould exercise in case the bank defaulted.

[163] I think I would be derelict in my duties as an officer of the company if I didn't insist on that.

Q. Paragraph 10 on page 12 of that exhibit states: "For so long as the bank is not in default with respect to its obligations under any of the exhibits, the bank shall have the sole and exclusive right to determine the name of the bank building," and the bank will have an irrevocable general election conforming to the requirement of Section 48 of the Internal Revenue Code of 1954, as the same may from time to time be amended, to treat the bank as having purchased any property which is purchased hereunder during the taxable year, and to perform such other acts with regard to Section 38."

This is in regard to the investment credit; is that correct? A. Yes. Section 38 is investment credit property.

Q. So even though you say Frank Lyon Company is putting the money into the building as it drew it down and was the owner of the building, you agreed to pass all investment tax credit, sales tax savings, on to Worthen Bank? A. That's correct.

Q. And Worthen Bank bore the ultimate risk of the construction of the bank; is that correct? A. We have an indemnity and hold harmless clause from them, yes.

Q. Mr. Dover just said that everybody assigned everything [164] to New York Life. Under Exhibit No. 27, the deed of trust Frank Lyon Company assigned its interest in the building lease, the ground lease, and the building to New York Life, and Worthen Bank assigned its interest in the land and garage; is that correct? A. That's correct.

Q. And even though it was your debt, Worthen Bank subordinated or added additional security to the debt of about $4 million of its own property. A. They subordinated the parking garage and the land. I don't know the value.

Q. Then I think it was a million four and a million two, about two million six. A. Like I say, I'm not familiar with the value.

Q. Under Exhibit No. 29, which is the Worthen Bank's consent and agreement with New York Life, they agreed to keep New York Life posted under paragraph 3 by giving them current balance sheets each year; is that correct? A. What page is that on, please?

Q. Paragraph 3.

The Court: Which agreement?

Mr. Sayre: Exhibit 29.

The Witness: In the consent and agreement.

Yes, that's correct.

By Mr. Sayre:

[165] Q. And all of these negotiations were—again, all of these instruments were tied into each other. They are interrelated. The terms of the deed of trust and the building lease and the ground lease are all interrelated. They are really all part of one basic transaction to build the Worthen Bank Building? A. Yes.

Q. Let's turn to Exhibit No. 19. A. Plaintiff's Exhibit 19?

Q. Plaintiff's Exhibit 19, which is the building lease itself. This is what is termed in real estate parlance a "net" lease; is that correct? A. That is correct.

Q. All obligations are upon the lessee to care for the building? A. Change the light bulbs.

Q. Pay for all expenses? A. Pay for the insurance and taxes. It is a net in real estate parlance.

Q. And the ground lease also places all the burden and responsibility for the upkeep of the land and paying the taxes and the indemnification of the Company, Frank Lyon Company, upon the Worthen Bank; is that correct? A. Yes, that retained those responsibilities as owner of the land.

Q. And again that was $50 for 25 years? [166] A. For the first 25 years, and then went up to $250,000 a year.

Q. Now if you will, go to paragraph 3.1 of that agreement.

The Court: Of the building lease?

Mr. Sayre: Yes, Your Honor.

The Court: What page is that?

Mr. Sayre: Page 2.

The Witness: Page 2, Your Honor.

The Court: All right.

By Mr. Sayre:

Q. That is the agreement to pay the lease—excuse me, to pay the rentals to—by Worthen Bank to Frank Lyon Company in an amount equal to the debt service; is that correct? A. This agreement is for Worthen Bank to pay Frank Lyon Company rent on the building.

Q. Which is an amount equal to the debt service of Frank Lyon to New York Life? A. These amounts are the same as the obligation to renew our note.

Q. May I ask why there is an increase in the payment after 11 years. A. This was part of the original arrangement and specification of sale and leaseback as Worthen Bank submitted to us on Plaintiff's Exhibit 13, paragraph 2. Each rental payment to be [167] required, 1 through 11 at lower rates and "B" is 11 through 25 at a higher rate.

Q. They are not the same amount, are they? A. Those are quarterly. I think there may be a little difference.

Q. But do you know why you negotiated difference in there? A. No, sir, I don't recall. The difference is pretty immaterial. Over a half million dollars in annual rent, it's less than a couple of thousand dollars.

Q. In paragraph 3.2 on the next page it says that the basic rent shall be absolutely net to lessor or assignee so that this lease shall yield to lessor or assignee the full amount of the installments of basic rent throughout the term of this lease without deduction. A. Yes, sir.

Q. Worthen Bank, then, had an absolute obligation to pay rent for the 25 year term of the lease. A. That's correct, without deduction.

Q. Now on section 5.1 of that page it also says that the basic rent, additional rent and any and all other sums shall be paid without notice, demand, counterclaim setoff deduction or defense and without abatement.

In other words, if your loans to Worthen Bank had gone bad, Worthen Bank could not set off the rent payments that they owed to you against the amount that you owed to them? [168] A. That's correct.

Q. Was this requirement put in here by New York Life who wanted to make sure they got their money? A. Section 5.1 was negotiated between the three parties.

Q. Again, going through this, the Section 7.1 the repair and maintenance of the premises were all upon Worthen Bank? A. Yes. "Lessee covenants throughout the term of this lease to take good care of the property and to keep it in good condition, excepting reasonable wear and tear."

Q. Section 11.1, which is on page 6, is another indemnification by the lessee of the lessor? A. Yes, indemnification and hold harmless clause.

Q. So Frank Lyon Company did not bear the ultimate risk of the operation of the building. If any suits were brought or any accident, injury, damage, so forth, against the lessor, Frank Lyon Company, Worthen Bank would accept the responsibility and the risk; is that correct? A. It would not relieve our legal responsibility. We could in turn look to Worthen for indemnification.

Q. And they had also agreed to indemnify you on the ground lease? A. Yes.

Q. Now on page 11 there is a sub-section 15.1—— A. Are we still on the building lease?

Q. Yes—which refers to the change and alteration [169] by the lessee. Under the terms of this arrangement, the bank was entitled to make changes that it desired in the bank building and if certain amounts were over and above a certain amount—the costs—then they would have to hire an architect or hire engineers to oversee it at your demand? A. That is correct.

Q. This same provision is contained either in the consent agreement or the deed of trust that if alterations are made that Frank Lyon Company would have to provide New York Life with the same assurances.

So, in other words, again we have responsibilities of Frank Lyon Company to New York Life being assumed by Worthen Bank; is that correct—the ultimate responsibilities? A. No, they are not assumed. Worthen Bank may have the same responsibility to us, but we are not off the hook.

Q. You would have to incur the cost of this? A. Yes.

Q. It would not be paid for by the lessee? A. We would require them to do it, but if they don't do it we have to pay for it under the deed of trust.

Q. But they would have to fail to keep their obligation under the terms of the lease? A. Yes.

Q. Under Section 17 on page 16, there is an agreement by the Worthen Bank to repair any damage or destruction to the [170] property. Therefore, the risk of repairs, and so forth, are upon the Worthen Bank and not the Frank Lyon Company to make any repairs or restructuring of the building; is that correct? A. Except for total destruction, yes.

Q. And under 17.2 the insurance money recovered on account of damage would be applied to the obligation of

the lessor, which is Frank Lyon Company, or the assignee, which is New York Life; is that correct? A. "Except as provided in Section 17.6 all insurance money recovered by lessor or assignee on account of such damage"——

Q. Paragraph 17.6 refers to the total destruction of the building, I believe, and that is a different obligation there.

So all risk is born by Worthen Bank rather than Frank Lyon Company during the term of that lease; is that correct? A. I'm sorry. Would you restate the question?

Q. The risk of damage, repair, and cost of insuring the property for the period of the time of this lease, initial term of this lease, is—in fact, I suppose for all time, that for the initial term of the lease—is upon the Worthen Bank and not the Frank Lyon Company? A. For the entire 65 year term of the lease, yes.

Q. Under 17.3, which is on page 18, it is the Worthen Bank's obligation to make payment of the basic rent and all items of additional rents and other charges on the part of the [171] lessee to be paid and to perform all covenants and agreements to be performed and these shall not be affected by any destruction or damage to the property. The bank waived the provision of the statute or law which would have a contrary effect.

In other words, there is an absolute obligation on the part of the Worthen Bank to pay a quarterly rental payment to Frank Lyon? A. To Frank Lyon Company, yes.

Q. Which in turn has an obligation to pay the exact amount over to New York Life? A. Yes. I think that's consistent with Section 5.1 which is the counterclaim abatement that we discussed earlier.

Q. Under 17.6, which is on page 19, if there was total destruction of the building on or after the initial 22 years of the lease, the board of directors of the bank shall decide whether to replace the building or to purchase the building from Frank Lyon or the assignee for an amount equal to the figures set forth in Table A, which is the purchase price,

if there is destruction of the building; is that correct? A. Yes.

Q. In other words, it's another option that the bank had if the building was destroyed. A. Total destruction, that's correct.

Q. Under 18.2, which is on page 20, they have the same right or the same option to purchase if the building is [172] condemned; is that correct? A. Yes, that is correct.

Q. On page 32, Section 29.2 it's understood and agreed that all rights under this lease will be assigned to New York Life as security for the note purchase. In other words, it's all part of the same transaction? A. I'm sorry. What paragraph again?

Q. It's 29.2 on page 32. A. Yes, that's an acknowledgement by both the lessor and the lessee that the lease will be assigned to New York Life as security on our note.

The Court: I'm just wondering if it might not be a better procedure unless you have some particular questions of the witness other than for him to identify the language, which speaks for itself and as to which the Court can read, maybe we could speed it up a little bit if you would identify each section you want the Court to read.

If you want to question the witness about the provision, that's fine; but just to ask him if a section does not say so and so, I think we could move faster. I do want you to, however, point out every section of these agreements that you want me to read. But I can do some of this outside the courtroom.

Mr. Sayre: Thank you, Your Honor.

By Mr. Sayre:

[173] Q. It's a fair statement to say that the ultimate risk with regard to the operation of the Worthen Bank Building are born by the Worthen Bank, not by Frank Lyon Company, due to the indemnification? A. The operation of the building?

Q. The operation of the building. Actually, the suits against it, against accidents in it, any obligation. The only thing that Frank Lyon Company actually has is their legal title. Is that correct? A. No, that's not correct.

Q. What else do they have? A. We've got $7,640,000 building. We've got a lease on that building, which is a net lease. We have extracted indemnity and hold harmless clauses against the tenant.

Q. Which, in effect, leaves Frank Lyon with the legal title to the building and no responsibilities—other responsibilities and risks attendant to ownership. A. No, sir, that is not correct.

Q. What other risks of ownership are born by Frank Lyon Company? A. The same risks that any landlord has of a tenant that doesn't live up to its obligation.

Q. You are saying that you assume that Worthen will default on its obligation? A. It's' entirely possible. We don't think so or we [174] wouldn't have entered into this agreement. But if they do, we are still liable to New York Life.

Q. The tax shelter created by the interest and the double declining depreciation deduction was one of the primary reasons? A. It was a factor that we considered.

Q. It was an important factor? A. Was it an important factor?

Q. Was it an important factor? A. Not especially, no.

Q. Then what in your opinion as a representative of the company was the important factor? A. The objective of the corporation to diversify.

Q. Even though title could be taken from it and any appreciation in value, or equity buildup could be taken from it by the bank? A. They'd have to give fair consideration for it. They did have an option to repurchase on four special dates in a 75-year period.

Q. In a 25-year period? A. Well, the ground lease runs for 75 years.

Q. But it can also be cancelled if the option is exercised on the building; is that correct? A. To purchase the building?

Q. Yes. A. Yes.

[175] Q. So, in other words, it all cancels at the same time, dependent on what the bank does? A. It depends entirely on the bank.

Mr. Sayre: Excuse me just a moment, Your Honor.

I have no further questions.

The Court: All right, Mr. Giroir.

REDIRECT EXAMINATION

By Mr. Giroir:

Q. Ralph, on this Coke loan that we have discussed, let me clear the air on that. Was there any conversation, agreement, understanding or other discussion between Frank Lyon Company and Worthen Bank that ir any way related the Coke loan to the credit judgment of Worthen Bank to tht building? A. Absolutely none.

Q. Is it your intention to repay the Coke loan? A. Oh, yes.

Q. When? A. We may be able to do it next year. Perhaps this year, '74. Maybe '75.

Q. It's been outstanding for some five years? A. Five years, yes.

Q. Did Worthen understand at the outset that it was going to be renewed annually? A. Yes, they did.

Q. Why did they exceed to that? How did you explain the [176] need for making it a five year loan? A. An analysis of the cash flow of Frank Lyon Company showed [we?] me perhaps could not pay it for a period of five years. As Defendant's Exhibit 18 shows, we had loans totaling $2,307,000 to the ex-Coca Cola shareholders. These required principal payments in four equal installments for a four-year period. That would be approximately $600,000.

Our agreement with Republic National Bank was to make 10 percent reductions of principal annually. That is approximately a quarter of a million dollars that we had in principal only that we had to pay the Republic National Bank. If you add those two together, that's about $850,000 in principal only.

We had to pay under the loan to First National Bank another approximately $50,000 and another $500,000 loan to Worthen, additional $50,000 annually. So when you have principal payments in one year on your debt service approximating a million dollars, plus interest on top of that, we just weren't sure we could make any reduction in that half million dollar note.

The Court: Was there any legal commitment made by Worthen to renew, or was this just——

The Witness: No, Your Honor, it was—we did ask for a one-year note and expressed to them at that time the cash bind that we would be in and said, "We might come back and ask you to renew the note."

The Court: Well, what if they had not renewed it? [177] Would you have any legal position?

The Witness: We would have no legal position at all. It would be a default under that note and we'd have to—it was not a secured note, Your Honor, but we would have had to go to another bank and borrow the funds or perhaps sell other assets to pay the note off. There was no legal obligation on Worthen's part to renew the note.

By Mr. Giroir:

Q. Was Worthen aware of all of these other commitments you had? A. Yes, they were.

Q. As a matter of fact, did you at this time have a line of credit with Worthen? A. Yes. Throughout this entire time we had a line of credit with Worthen, and still do.

Q. What was the amount of that line? A. Depending on that time somewhere between a million and two million line of credit.

Q. Would it have been possible for you to have drawn down on that line of credit and paid down on this note? A. Yes. It would have been, unless the same factors that would cause them to fail to renew might have caused them to cancel the line of credit also.

Q. You had explained to them had you not, that it might be some period of time? [178] A. Yes. As a matter of fact, it would probably be at least five years because of the very heavy debt service on the note to the ex-Coca Cola shareholders.

Q. Was the net worth or the aggregate of the four or five notes to the ex-Coca Cola shareholders secured by anything? A. Secured by all of the stock in the Coca Cola Company.

Q. In point of time, just for frame of reference now, when was Coca Cola purchased? A. August the 21st, 1969.

Q. Going back to 1968, when was the Twin City Bank stock purchased? A. In June of 1969—'68. I'm sorry. In June of '68.

Q. The question was asked earlier whether or not there was any connection between the purchase of the Twin City Bank stock and your commitment to purchase this building? A. Absolutely none.

Q. Your commitment to purchase this building was entered into on what date? A. Oh, our proposal was accepted around November the 1st of 1967.

Q. And have you, since your testimony earlier this afternoon, determined when Henry Tupp, the principal stockholder of Twin City Bank, died? A. He died in November of 1967, and it was in the spring of 1967 when—late spring or early summer when the executors [179] of his estate elected to sell Mr. Tupp's stock or the estate stock in Twin City Bank.

Q. Was there any connection between your commitment to buy Twin City Bank stock and your commitment to buy the Frank Lyon Building? A. None whatsoever.

Q. Now the proposal which you made which was accepted—your second proposal to Worthen Bank—indicated that you would reduce the lease payment to an amount $21,000 per quarter per year — A. Per year.

Q. ——less than the note payment? A. That's correct.

Q. In fact, is the lease payment $21,000 a year less than the note payment? A. No, it's not. We tried to do this and agreed with Worthen to sign a lease to that effect, but New York Life would not accep. our assignment of the lease with that provision in it.

Q. Then did Worthen forego its $21,000 a year? A. No, they did not.

Q. Did you have any proposal as to how you would get that $21,000 a year to them? A. Not at that time. We were spending 40, 50, 60 hours a week really negotiating these documents, and we agreed with Dick Gates that the most important thing was to go ahead and [180] get this transaction closed and then we'd worry about it.

Shortly after that I had suggested to Frank Lyon to go ahead and write them a rent rebate check in December of some $21,000.

Q. Is that $21,000 each year? A. Yes, for a four or five-year period.

Q. What was his response to that? A. He didn't think much of that idea.

Q. Why not? A. He felt like this would really be an agreement outside of the lease payments or the rental payment—the lease we had signed with Worthen Bank and which we had assigned to New York Life—and there ought to be a better way to get the $21,000 to Worthen.

Q. Did he still recognize the obligation to pay the $21,000 a year? A. Yes, he did, and suggested that I find out a way to get the $21,000 to them before the end of the year.

Q. Did you have a proposal in that respect? A. Not at

that time. However, in about August of 1969 when I realized that we were going to have to borrow some additional money from Worthen Bank and furthermore that we would not be able to pay it back as fast as we had our other borrowings, the idea popped into my head of suggesting maybe in the negotiating allowing Worthen to charge us or consenting to [181] Worthen's charging us more interest than we normally pay to Worthen.

Q. You mean pay a higher rate? A. Yes.

Q. Did you have outstanding loans to Worthen at that point? A. Yes, at that time we did. We had borrowed a half million dollars in late '65 or '66 which were retiring at $12,500 a year as shown in Defendant's Exhibit 18.

Q. Did you renegotiate that loan to agree to pay additional interest on it? A. Not the outstanding one, we didn't.

Q. Did you agree to pay additional interest on any loan? A. We did agree to pay additional interest on the $500,000 that we were about to borrow in order to pay the down payment to the ex-Coca Cola shareholders.

Q. How much in percentage? How many additional percentage points did you agree to pay? A. It was around three and a half percentage points more than we normally were asked to pay. Normally we were able to borrow money at Worthen's prime rate, and at this particular time it was around six percent. We negotiated that note at around nine and a half percent. Maybe prime was six and a quarter.

Q. What is that? Approximately three and a half percent on $500,000? [182] A. Three and a half percent on $500,000 was close to $20,000.

Q. Did you intend to continue to pay that excess amount of rent over the full period of time of your commitment? A. Actually, it worked out very, very well for us because as I have testified earlier the notes to the Coca Cola shareholders were due in four years and we would really, from an economic standpoint, not be able to pay any. So when

we had explained this to Worthen, that was an additional reason that we used to induce them to continue to renew the note over the five-year period.

Q. When you say "that", what do you mean "that was"? A. Our commitment to reduce the rentals by approximately $21,000.

Q. And when does that five years expire? A. '69 to '74. I think it's in December of this year, as a matter of fact.

Q. So that if you pay excess interest over five years you will have compensated Worthen? A. That's correct, if you take six percent as a fair rate of interest.

Q. During the construction period while you were borrowing from First National City Bank, how did you mechanically handle the payment of the interim interest obligation? A. We—the note calls for a monthly adjustment of the [183] interest rate, according to First National City Bank's best commercial rate in existence at the first of the month.

They would send us notification as to what this rate was as well as the principal amount outstanding and we would write a check and mail it directly to New York—First National City Bank in New York to pay the invoice.

Q. How was it paid? A. Monthly as required by the building note.

Q. Mr. Sayre asked you if there was a cash flow during the first 25 years of the building and your response was, "No." Were you speaking in terms of a before or after tax? A. I was speaking in terms of a before tax cash flow.

Q. Was there an after tax cash flow? A. Yes. As I testified there was a cash flow during the first 11 years of approximately one and a half million dollars. Likewise, a negative cash flow of perhaps a little less than that in the subsequent 15 years, 14 years.

Q. In your experience in the real estate investments, is it unusual for there to be no positive pre-tax cash flow? A. Not at all. As I have already testified, in all of our real

estate investments that I am an officer in the corporation there is no substantial cash flow. The debt service and the rental payment are not identical. The differential between the two is only sufficient to pay a nominal management fee to Frank Lyon and to pay the franchise tax to the State of Arkansas.

[184] Q. Your $500,000 "equity" in the building represents, I suppose, what percent? Approximately seven percent of the total cost? A. Yes, approximately seven percent of the total cost.

Q. And in your experience in real estate investments is it unusual to borrow out 93 percent on a real estate project? A. Not at all.

Q. Is it unusual to borrow more? A. Some people have been known to borrow more. Some people have been known to borrow a hundred percent.

The Court: Or maybe even more than a hundred percent.

I think we better have a break. We will be in recess until a quarter to 5:00, and then we will go to 5:30. I think that is all we can do in terms of imposing on the court reporter.

(Recess.)

The Court: Let me find out a little bit about the $21,000. The Frank Lyon Company in trying to get this project tried to underbid——

The Witness: Yes, Your Honor.

The Court: ——and they were not privy to what the other interested parties were doing and so they wanted to try to anticipate and offer something to Worthen that would make it sure they got the package; is that correct?

[185] The Witness: Correct.

The Court: Now as it turned out, are you saying that New York Life did not want, in effect, the investor agreeing to a rental that was not at least enough to pay the principal and interest payments required; is that correct?

The Witness: That is correct.

The Court: So the documents were executed accordingly.

The Witness: Correct.

The Court: Now, then, you are saying when your boss was saying, "How could we honor this commitment," it was discussed to write a rebate check every years for 25 years?

The Witness: Correct.

The Court: Is this Mr. Lyon that did not want to do that?

The Witness: Yes, it is.

The Court: When all these documents were entered into here it was in what, May of '68?

The Witness: May of '68, Your Honor.

The Court: So what happened? Did this just hang fire about how to handle this problem?

The Witness: Yes, it did, and I was supposed to solve it before the year ended.

The Court: And you did not, or did you, before that year?

Mr. Giroir: Your Honor, the first lease payment wasn't [186] due until March of '70.

The Court: I see.

Mr. Giroir: So the problem didn't become a reality until then.

The Court: I see. It became a problem after March of '69.

Mr. Giroir: March of '70. The building was completed in November of '69 so the first rental payment was——

The Witness: Three months later.

Mr. Sayre: March of '70.

The Court: So eventually when the opportunity for the Cola Cola stock came along and you had to borrow money you, in effect, paid more than you had to or would have ordinarily had to in order to perform on your agreement or your commitment to Worthen?

The Witness: That's correct.

The Court: And it was just something that was to be renewed on a year-to-year basis and as it, in fact, worked out you expect this commitment will be discharged by five renewals of that note?

The Witness: Just the way the circumstances worked out. The ex-Coca Cola shareholders demanded their installments over four years and this did sap us for four years and we really needed to borrow the money for five years anyway. It did so happen that was also the length of time we had promised to reduce [187] their rent.

The Court: In the dealings was Worthen insisting upon this and saying, "All right. Let's get this behind us but after all, you made this agreement," or do you know anything about the actual negotiations with Worthen about this $21,000 other than the report to you that, "We need to work out something to pay it and you figure out a way." Besides that, were you in the negotiations with Worthen about this matter?

The Witness: Only to the extent that we first went in and, "We'll reduce the lease payments in the lease by $21,000."

The Court: Until New York vetoed it?

The Witness: Until New York vetoed it. At that time I dropped it. I was working full time on this deal.

The Court: I don't know that Worthen will be interested in dropping some hundred thousand dollars without some understanding. Do you know how that was picked up by Worthen?

The Witness: No, I do not.

The Court: You may continue, Mr. Giroir.

By Mr. Giroir:

Q. Mr. Cotham, for the purposes of identification let me refer you to Defendant's Exhibit 18. You've got circled at the left top the year 1969. A. Yes.

Q. There is a loan designated "Journal Entry, J E"—— A. Zero 080. We use five digits. We have so many journal [188] entries during the year we use five digits to designate them all.

Q. There is a designation "Stockholders C A C". A. That's Coca Cola.

Q. $2,700,000. A. That's correct.

Q. It's your statement this is the loan to the Coca Cola stockholders? A. That is correct. The ex-Coca Cola shareholders.

The Court: How much was that?

The Witness: $2,307,074.

By Mr. Giroir:

Q. Is that the loan or the aggregate of the loans you agreed to pay over a four-year period? A. That's' the total of the notes over the four-year period.

Q. On the following page next to the bottom there is a journal entry that bears the same number designated "Worthen Coca Cola" in the amount of $500,000. Is that the $500,000 loan from Worthen Bank obtained to fund part of the down payment for the Coke stock that we have

been discussing. A. That's correct and so identified in two places. The journal entry is identical and, secondly, to distinguish this from the other Worthen Bank loans it's designated "Worthen-Coca Cola".

Q. Who owns the balance of the stock of the Frank Lyon Company? [189] A. Some of it is held in treasury stock. Approximately--I think Mr. C. W. Abrams owns around five percent and there are about four other officers that own less than one half of one percent, and Frank Lyon, Jr. owns approximately one or two percent himself.

The Court: How much?

The Witness: Frank Lyon, Jr. owns approximately one or two percent, Your Honor.

By Mr. Giroir:

Q. C. W. Abrams, is he an officer of Frank Lyon A. Yes. He has been with the company since the 1940's and is now president of the corporation.

Q. All of the stock, other than that owned by Frank Lyon and Marion Lyon, his wife, then, is owned by employees of the company? A. Yes, with the exception of some of the Lyon stock that I believe has been given to other family members as trustee as part of their estate planning.

It's all owned by members of the Lyon family in trust of which they are beneficiaries, with the exception of less than ten percent which is owned by other officers of the company; the primary officer being C. W. Abrams, who owns approximately five percent.

Q. As to the increase or decrease in the value of the building over the term of these leases, I call your attention [190] to the fact that your ownership is of the building only and, therefore, no increase or decrease in the ground valuation has an effect on the value of the building. A. That's correct.

Q. How did that figure into your determination on the front end of what the building would be down the line? A. Mr. Giroir, it made it quite a bit easier to try to determine. You could look back in 1967, '68, and see what land values had done in the preceding 25 years and realize what a difficult thing it was to try to look out for 10, 15, 20, 25 years to really estimate what the fair market value of the land would be.

When you are purchasing and owning a building, which is depreciable, it's a little bit easier to quantify.

Q. What effect on that determination, prospectively of what the fair market value would be, did the existence of a long-term lease with renewal options have? A. It certainly had an effect on it. The fact that we, as owner of the building, had executed a long-term lease, which at the sole option of the tenant, could be extended as long as 65 years would certainly—would be a factor in determining the value of the building.

Q. Would that same factor be considered by a purchaser? A. Absolutely.

Q. This unusual arrangement by which you purchased the [191] building on a brick-by-brick basis, was that at your suggestion or Worthen's suggestion? A. Not at all. I was really hoping we could see the finished product and then buy it from them. It was solely at Worthen's suggestion that we do it on a brick-by-brick basis.

When I pushed them on it I learned that there were two reasons for this: one was to escape the provisions of the Arkansas Sales Tax. In other words, if they continued on with their contracts, purchased the materials that were put in the building, those materials would not be subject to Arkansas Sales or Use Tax at that time.

Frank Lyon Company was subject to the sales tax provision and, therefore, would have to pay additional three percent of—don't know what portion of the total cost was labor or materials. Even three percent of $4 or $5 million would be $150,000.

The other one, which Mr. Dick Gates told me, was the concern of the Worthen bank officers in not having this for an excessive amount of real estate appear on Worthen's books. They did not want to wait until the building was completed. They wanted us to start taking title to it now, immediately.

Q. Did that unusual arrangement have any effect on the type of protective covenants you obtained from Worthen? A. It certainly did. We didn't know, number one, whether Worthen was going to complete the building. We didn't want to [192] buy a pig in a poke. Had we been able to wait until the building was completed we would walk around and see what it looked like and get structural engineers to certify that the building is going to stand up in hurricanes or tornadoes or other types of rains, but know that the roof doesn't leak and the elevators work, and that it is a functional building.

Q. Did that relationship give rise to the indemnification provision which Mr. Sayre was questioning you about? A. It certainly did. That was the only way, really, that I could see as a viable option that Frank Lyon Company could protect itself.

Q. As to these provisions we have discussed on damage, destruction, condemnation, what was your question for being so hardnosed about that? A. Well, as an officer of Frank Lyon Company I was trying to make the best deal I could for my employer.

Q. Do you think you protected him in that regard? A. I certainly tried to do so. Hope so.

Mr. Giroir: I have nothing else, Your Honor.

The Court: Mr. Sayre.

RECROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Cotham, in regard to the other types of rentals or buildings or leasing arrangements that Frank Lyon

family has, do those involve options to purchase also? [193] A. I cannot recall. There may be one that does.

Q. So, in other words, there are not leasebacks—— A. For the main part, that's right.

Q. And there's a small, minimal cash flow on these.

With regard to Mr. Abrams' stock in the Frank Lyon Company, is there an option to repurchase if he should leave the company? A. Yes, there is.

Q. You said that the $500,000 loan made in August of 1969 was unsecured? A. That's correct.

Q. So were the other loans secured, or were they all unsecured? A. No. The other half million loan, which we negotiated I think, in '66 with Worthen Bank, was unsecured. The half million dollar loan to First National was unsecured. The Republic loan was secured by the stock that we had purchased in Twin City Bank and the loan to the ex-Coca Cola shareholders was secured by stock. The note to Whirlpool was unsecured and the $114,000 on notes payable was unsecured.

Q. You said with regard to the $500,000 loan that there was not commitment, no understanding with relationship to the bank of Frank Lyon Company buying the bank. A. That's correct.

[194] Q. Now you come back and tell the Court there was an understanding to pay higher interest with regard to that loan so as to make a kickback of $21,000 per year for approximately $21,000 under the agreement that had been reached in October or November of 1967. Is that your testimony? A. No, I don't think you have fairly summarized it.

Q. What was your testimony? They were interconnected because of the agreement to reduce the rental? A. They were not related at all. We did have an obligation——

Q. Then the nine percent interest has nothing at all to do with the reduction of the rental or anything else; is that correct? A. In our letter in November of 1967 we promised to reduce the rental payments during the five-

year period of $21,000 annually. We tried to execute a lease.

Q. I understand that, Mr. Cotham. My question is: Is there a connection between the loan? A. No.

Q. Then the nine percent interest has nothing to do with the payment of $21,000 in reduction of the rentals in the agreement to buy the building; is that correct? A. The difference between a six percent—approximately six percent prime rate at that time and nine and a half that we did pay, does——

[195] Q. Is it nine or nine and a half? A. I don''t recall. There was about a three and a half percent spread, and I do not recall whether prime at that time was six or six and a quarter.

Q. My question again is: There was a connection, then, between the loan and the payment of the interest on it and the agreement to hold it out connected with the agreement of Frank Lyon Company to purchase the Worthen Bank Building? A. No, not at that time. The loan was made to pay the down payment to the ex-Coca Cola shareholders and, in fact, that's where the proceeds went.

Q. You are saying the payment of interest—there is no relationship between that loan and the prior agreement of Frank Lyon Company?

The Court: As I understand his testimony, that at the time of the first transaction the Coca Cola transaction was not even under consideration but it became the vehicle to discharge this obligation that they committed themselves to at a later date when it arose.

The Witness: That's correct, Your Honor.

By Mr. Sayre:

Q. What I'm asking is: Is the payment of part of what is called interest to Frank Lyon really a reduction of the rental payments? A. Economically it has the same effect. We are paying [196] interest.

Q. Was it intended to be a reduction of the rent? A. No. It was intended not to be a reduction of the rent because they had an agreement with New York Life that we could not and would not reduce the rents.

Q. What I'm asking is: Frank Lyon deducted that additional payment of $21,000 a year of interest on their income tax return and the Government paid half of it. A. The Government didn't pay any of it.

Q. By taking the deduction on interest? They got a deduction at the forty-eight percent bracket, didn't they? A. Interest is a deductible expense.

Q. And so in effect, because of the tax rate what you are saying is that the reduction was paid for half by Frank Lyons and half of it was paid by the Government through a tax reduction. A. No.

Q. What I'm asking you is—— A. The rent——

Q. ——was the amount paid intended to be interest or was it a reduction on the rental? A. It was intended to be interest and was so negotiated and so stated on the face of the note.

A factor in negotiating the rate of interest was our prior obligation to reduce the rentals by approximately $21,000.

[197] Q. But you say there is no connection with the renewal each year of this with regard to the fact Frank Lyon Company put $500,000 into the construction? A. Even if Frank Lyon Company had not agreed to reduce the rentals by $21,000, we would have wanted to borrow that money for a five-year period. This was dictated by the——

Q. And that five-year period expired in August of 1974, and it has not been paid; is that correct? A. That's correct.

Q. And it's been renewed for another year? A. I believe that's correct, or we might have changed the maturity until December. We may renew it again.

Mr. Sayre: No further questions.

The Court: Anything else of this witness?

Mr. Giroir: Just one question, Your Honor.

REDIRECT EXAMINATION

By Mr. Giroir:

Q. As far as you know, did the $21,000 in additional interest have anything to do with the credit decision? A. Absolutely not. As a matter of fact, it would have to be—you know, four percent of a half million is only $20,000, so it does not exactly correlate to any $21,000 rent reduction.

Q. Now there was some discussion there a minute ago about the Government paying half of that $21,000. Isn't it [198] true it's in effect, a wash? How does it wash out? Does the excess rental wash against the excess interest as far as taxes are concerned? A. It would. I would have the—that's right. The tax effect is the same as if New York Life would accept an assignment of a lease which had $21,000 less rentals in the first five years. Exactly the same.

The Court: You may stand down.

(Witness excused.)

The Court: Call your next witness.

Mr. Williamson: Plaintiff would like to call as its next witness Mr. Edward M. Penick.

The Court: Mr. Penick, come forward, raise your right hand, and be sworn.

Thereupon

Edward M. Penick

having been called as a witness by and on behalf of Plaintiff, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

By Mr. Williamson:

Q. Will you please state your name and address? A. Edward M. Penick, 13540 Rivercrest, Little Rock, Arkansas.

Q. How old are you, Mr. Penick? [199] A. Fifty-two.

Q. What is your present position with Worthen Bank? A. I'm chairman and chief executive officer.

Q. And how long have you held that position? A. I have held that position since the early this year.

Q. And prior to 1974 what was your position with Worthen Bank? A. Most recently I was president and chief executive officer, and I have held various positions prior to that time.

Q. Between 1961 and 1974 were you president of Worthen Bank? A. Yes, sir.

Q. And chief executive officer? A. Yes.

Q. Would you please briefly state what your prior educational and professional training has been? A. I graduated from Little Rock Central High School, the University of Arkansas College of Business Administration and University of Arkansas School of Law.

Q. And have you had any professional training in banking and formal training in banking? A. I completed the Graduate School of Banking at Rutgers University and the School of Bank Marketing and Public Relations at Northwestern University.

Q. What offices in banking associations or organizations [200] have you held, Mr. Penick? A. I have been president of the Arkansas Bankers Association and president of the National Banking Association known as the Bank Marketing Association.

Q. Moving, now, Mr. Penick, to the background of the move into a new building, will you please state briefly what building you occupied prior to moving into the new Worthen Building and what lead you to a desire to get

out of that building? A. Prior to the time we moved into the present Worthen Building, we were in the building at 401 Main Street which we had occupied since 1929, at which time we were about a $3 million bank when we moved into that building. We had grown to about $107 million bank at the time we moved into our present building. We had remodeled the 401 Main building twice.

We had built a drive-in and parking facility and office facility behind it or had leased it. It had been built by other people, but we leased the parking and drive-in facility. We were at that time completely out of space and were faced with the problem of remodeling again, adding to, building on, or building a new building.

Q. Incidentally in the old facility did you own the parking deck that became an integral part of the building? A. No. We were a tenant of the parking deck. There was a separate organization. We leased the ground floor where [201] we had our drive-in. They built some office space along the fourth street side, and we leased all the office space and sublet the office space to some tenants but utilized most of it ourself. But the parking people operated it as a commercial parking garage.

Q. And these were people who had no connection whatsoever with Worthen Bank? A. Yes, sir.

Q. When did you begin to make plans to move out of your own building? A. We talked about it, I guess, for about two years, 1962-1963 and '64 and there was some difference of opinion among our board of directors. Some of the older directors said "You can't leave Main Street. Your corner is at Fourth and Main." At that time, Blass Department Store was still in existence and Fourth and Main was probably the number two corner in the City.

Many of the other directors felt like we couldn't build the type of facility we wanted to have on that corner even if we could acquire the adjoining theatre and other properties. We put out some feelers to determine if we could

acquire the theatre, and the price that came back to us was non-acceptable. So in order to resolve exactly what we should do, we retained a real estate consultant firm named James Landauer Associates of New York City to advise us on what we [202] should do, where we should go, how big we should build it, and how to finance it to be consultants to help us in this major decision.

Q. What were their recommendations, first with reference to the location of the building?

The Court: Describe the Landauer firm.

The Witness: Their title is real estate consultants. They don't do any building. They are a very fine firm, very well recognized firm. They have done a good bit of work in this part of the country.

First National Bank of Memphis is the place that we got their name. They had done the analysis of their problem. They had a similar problem, and I think they are one of the top real estate consulting firms in the country.

The Court: Very well.

By Mr. Williamson:

Q. And what was their recommendation with reference to the location and size of the new facility? A. They recommended that we attempt to acquire the three-quarter block site where our building is now located and that we build a 10 story office building.

Q. Did they also make any recommendations with reference to finance? A. Yes, they made a number of recommendations on financing: finance it ourselves on our statement would probably be the [203] least expensive way to do it; to create a real estate holding company off our statement, finance it on that basis; to just find an investor and let him build the building and we just be a tenant in the building and let him speculate on the rest of the building; sale and leaseback was another manner that they pro-

posed that we consider. There may have been another. There was a section in there on recommendations.

Q. At the time they recommended the acquisition of that site who owned that site or was it in the process of being acquired? A. The Little Rock Housing Authority was in the process of acquiring it. I don't know whether they owned the full site yet. There were 17 or 18 different parcels in that block. It was part of the down town urban renewal project and was being acquired by the Housing Authority.

Q. And would you just briefly explain what you had to go through with in order to bid for and be awarded that site. A. Well, the bid was not just on a price basis. They had a public ad. Anybody interested in making proposals on this site could make submission to the Little Rock Housing Authority.

The bid was not just solely on price. You might be the highest bidder pricewise, but if you were not going to develop the property in keeping with the redevelopment of the down town area, you would probably not be a successful bidder.

[204] Our bid did include and was required by law to include not only the price but also schematics, outlines, layouts, of what we planned to do with the site.

Q. And this was in 1965 and 1966—— A. '66.

Q. —that you were negotiating for this site.

When did you begin to make contacts with lendors and investors to discuss the financing of the business and who were some of the earlier people you went to in that connection? A. Well, along about the same time that we were studying proposals and making proposals to the Housing Authority, we also had committees working on the design of the building, our needs within our own organization, what we could project, the size of the building we would need over the next 25 years; another group working on how we were going to finance this project. These contacts were going on simultaneously in 1966.

Q. Do you remember the names of some of the people that you contacted? A. Either I contacted or representatives of the bank contacted—I didn't contact all these people personally—but the Bank Building Corporation of St. Louis who had originally built our building in 1929. We talked with them at length and received a proposal from them.

We talked with the Chase Manhattan Bank; White, Weld which is an investment banking firm in New York; talked with [205] Brooks, Harvey, Smith, Barney; Eastman Dillon; others. There is a number of others. We talked with the National City Bank of New York, real estate section.

Q. What about Solomon Brothers and Holtzen? A. Solomon Brothers and Holtzen and something Westerveldt.

Q. Hubbard Westervelt and Mottelay? A. Hubbard Westervelt.

Q. What about J. Halperin and Company? A. Yes, sir, we talked with them. We talked with about anybody that would talk to us about financing the building, anybody that had any experience in that area. We talked to almost all those people and received proposals from most all of them.

Q. By way of background would you also state what was happening, insofar as your chief competitor is concerned, with its building plans? A. Well, the Union National Bank had acquired an urban renewal site in the down town area and were in the process of putting together a building program. They were probably six months ahead of us in their planning for the type of building they were projecting to build, and there was some anxiety about who would be completely first so they would be able to attract tenants into the new office building.

Q. What happened with reference—you say they were about six months ahead of you in timing. Were you able to catch [206] up with them and how or what happened that enabled you to catch up? A. There was civic project developed that was called Capitol Place, the idea being—and I don't know where it originated—but to build an under-

ground parking in the center of the downtown area to hold about 2200 cars.

Mr. Louis Rosen was one of the principal motivators behind it. It would be under the plot where we were going to build, under the street, under the plot where the Union National Bank was going to build and under the plot where the old Franke's Cafeteria used to be. It would tie in underground to the major department stores and back into Main Street. We would anchor the downtown center of Little Rock around this 2200 car parking garage.

In order to give that time to develop, the Union National Bank and our bank agreed not to go forward with the groundbreaking and actual construction on our building until Capitol Place had had an opportunity to run its full length. That span of time gave us a chance to get our banking caught up to where we were pretty well ready to go when Capitol Place was not able to come into fruition.

Q. That project fell through sometime in the summer of 1967, I believe. A. Yes.

Q. And at that time had you completed all of your plans [207] with reference to the building? A. No. We were under a new theory of building. Rather than complete all the detailed plans and specifications, we were building under a theory of building against a budget. The architect and the engineers and contractors were just staying ahead of the actual building of the building.

Again, I mentioned we had been very close to the First National Bank of Memphis and we visited with them. They had just abo t two years before completed their building.

We counseled with them and got their help and advice and this is the way they had built their building. They had been able to speed up the construction considerably because they did not have to have a fixed price and bid. They did not have to have all the detailed architectural plans and specifications completed before building was started.

Q. One other problem with reference to delay and finally acquiring the building site. Was there any problem with reference to an alley which resulted in delay? A. We submitted our bid and the Housing Authority represented to us that the alley running north and south through the center of the block would be closed. We could so design our building around it.

When the Housing Authority attempted to close the alley, one of the joining tenants objected and said he would go all the way to the Supreme Court of the United States before he [208] would see the alley closed, which we anticipated would take at lease two years. So we negotiated with him and agreed to open the alley into Center Street. Now the alley that runs east and west from Center Street into the old north-south alley is a public dedicated easement even though it fits into the overall plan of our building. That's how we were able to negotiate that with our neighbor tenant.

Q. Do you remember when that problem was cleared up and you were able to acquire the site? A. It would be in the summer of 1967 since we started construction in August of '67.

Q. Did you start construction in August? A. July.

Q. Do you remember the date of closing of the site? Does September 15 ring a bell? A. Yes. Because we tried to get the Housing Authority to let us not pay for the land. We tried to lease the land on a long-term lease. They did have a program [sense?] could lease, under certain circumstances, land on a long-term lease. We tried that and that didn't work.

Q. It's a fact that the purchase of the site was closed on September 15, 1967? A. Yeah, I believe that's right.

Q. Is it also a fact that construction began on September 15, 1967, the very day you closed? [209] A. Yes.

Q. At that time had you completed arrangement in connection with the financing of the building? A. No, we had not.

Q. Why, then, did you proceed to begin the construction as soon as you acquired the site even though you had not completed the financing arrangements? Did this have anything to do with Union National Bank? A. Again, we were anxious to have our building completed as quickly as possible because we were building a building which we were only going to occupy about a third of it.

We felt a very strong responsibility to have tenants in it as quickly as possible. The Tower Building's tenants were coming up on their first 10-year renewals and they were the prime target. We knew the Union National Bank was working very hard on them and representing a much earlier occupancy date than we could. So we felt it extremely important to us to get started, plus we were coming up out of the hole in the ground before the winter was on us.

Q. I believe you have stated that you made contacts with a lot of investors and lending agencies. Who else in the bank did a lot of the contact with potential investors or lendors and worked on financing plans? A. Dick Gates, who was a vice-president in charge of [210] our investment division, was in charge of the finance committee charged with lining up the financing: how we were going to finance this building. Dick had that responsibility. He did a major portion of the day-to-day work on this project.

Q. Is he still with Worthen Bank A. No, Dick is retired and lives right out of Tampa, Florida now.

Q. In connection with proposals that you received from a large number of potential investors or lendors, what were the basic types of proposals they made? A. Well, we received proposals for joint ventures where we would go in with some major owner and they would own a part of it and we would own a part of it similar to what the First National Bank of Little Rock has done with two other investors.

We received proposals from companies where they would build the building and lease us the space we needed and they would take the risk of leasing the rest of it and we could draw plans and specifications and we could build the type of building we wanted to build. We were very conscious of the fact we wanted a prestige building and wanted it to be a building that was not just in circulation as a regular office building but one that would stand for many years and be symbolic of the type of organization we try to portray. We received all kinds.

Q. Were there any suggestions that Worthen own the property and finance it through any conventional mortgage loans [211] or any assortment of capitol notes or debentures? A. That's what we wanted to do. First, we wanted to carry it on our books. We determined that was not possible or doable because of the regulatory authorities' limitation as to the amount of capitol you could carry on your books.

That would have been the least expensive way for us to do it because our cost of funds is less than what we could go into the market and borrow it. That was the most advantageous way for us to finance the building.

The regulations—and we were a state bank at that time. We have since converted to a national bank. The regulations of the State Bank Commissioner and the Federal Reserve who were the two supervisory agencies, would not permit you to put more than the amount of your capitol stock or 40 percent of your capitol and surplus, whichever is less, in real estate. We couldn't come under those regulations.

We elected next to organize a real estate holding company for the bank to sell debentures to the public in the amount of $4 million to buy the land and then to lend to the real estate holding company the $4 million, and the real estate holding company use that as equity to borrow the additional money—we thought it would take about $9

million total—borrow the additional money on a conventional real estate loan to finance the building.

That way it would be off our balance sheet. We thought [212] it would not be charged against our capital account and we proceeded to develop that idea.

Q. Before we go on with that idea, on the acquisition of the site did you obtain the approval on the acquisition of the site—— A. Yes.

Q. —from any of the bank regulatory authorities? A. Yes, from the State Bank Commissioner, who was the primary regulatory authority.

Q. And also did you obtain the authority—did you have to take this before the Federal Reserve Bank of St. Louis? A. Yes.

Q. Would you explain a little more in detail why you were governed by two regulatory authorities: both the State Bank Commissioner and the Federal Reserve Bank of St. Louis. A. As a state bank we were not required to go on to the Federal Reserve System. It was optional on our part. Being in a reserve city such as Little Rock, being very active in the correspondent bank business—we had been a member of the Federal Reserve for many, many years—we had a dual supervision. Our primary supervisor was the State Bank Commissioner. However, we had to comply with both regulations. We were examined by both groups. We must comply with both their supervisory directives and we had a dual—we had two bosses.

Q. I believe, Mr. Penick, I won't take time to read it [213] but will simply call your attention to the fact that Plaintiff's Exhibit 37 contains the consent of the Federal Reserve Bank of St. Louis to the acquisition of the site. That's a letter dated August 22, 1967. A. Yes, sir.

Q. Now getting back to your first proposal or first plan to have a wholly-owned subsidiary own the building, Worthen would sell $4 million in debentures, invest the money, use that money to buy capitol stock of the wholly-owned subsidiary; and then the wholly-owned subsidiary would

finance the balance of the construction—estimated construction cost of $9 million how? Through a conventional mortgage? A. Through a conventional mortgage loan.

Q. Was that plan spelled out to both regulatory authorities? A. Yes, sir.

Q. I believe you introduced into evidence—we have Plaintiff's Exhibit No. 1, which is a letter to Mr. O. O. Wyrick dated August 26, 1967, which spells that plan out, does it not? A. Yes, sir.

Q. And you are requesting their approval of that plan? A. Yes, sir.

Q. I believe that letter concludes: "We expect to begin construction as soon as we have received approval and your early consideration is appreciated."

[214] Was almost an identical letter written to the State banking authority? A. Yes, sir.

Q. I believe you will find that on—well, I don't believe we introduced that as an exhibit, but almost an identical—

It's mentioned in the letter that as soon as we received approval of the State Bank Commissionertheir actions are not contingent upon each other. They could act independently. The State Bank Commissioner could approve it at the same time the Federal Reserve in St. Louis was considering it. We didn't have to get one's approval prior to submitting it.

Q. So you submitted it—about the same date you wrote to Mr. Wyrick in the Federal Reserve Bank you wrote a similar letter to Mr. Adams? A. Yes, sir.

Q. Then what happened with reference to that first proposal? A. I got a telephone call from Mr. Wyrick calling attention to the fact that if the real estate company was a wholly-owned subsidiary of the bank, that the investment in the real estate company would be charged the same as if there was an investment on the bank's books. Consequently, that was not doable under those circumstances.

Q. That applied not only to the investment of Worthen in the stock of the wholly-owned subsidiary but any indebt-

edness [215] of the wholly-owned subsidiary to acquire the building would also be counted the same as if it was invested by Worthen on its own books in banks premises; is that correct? A. Yes.

Q. And if it exceeded the $4 million, what would be required? A. Well, we could have exceeded the $4 million but in order to do so you must get the Federal Reserve in Washington approval. The local Federal Reserve Board, the St. Louis Federal Reserve Board, the Eighth District did not have the authority. You had to go all the way to the Federal Reserve Board in Washington, D.C. They did not have authority to waive that requirement.

Q. Did you talk to Mr. Wyrick about waiving the requirement? A. Yes, I talked to him about the probability: did he think the Federal Reserve Board in Washington would be acceptable to our proposal and would they waive it.

Q. Incidentally, does the Federal Reserve Board in St. Louis have to make any recommendations with reference to waivers that go to Washington? A. He makes a recommendation to the Board in St. Louis—Mr. Wyrick does—and they in turn make a recommendation.

Q. What did he tell you their recommendation would be? A. He said he could not recommend it. He didn't say he [216]—he would recommend against it; he just said: "I cannot recommend it."

Q. Did you also have any discussion with a Mr. Britton Leavitt in Washington on this subject? Who was Mr. Leavitt? A. Mr. Leavitt at that time was the chief examiner for the Federal Reserve System. I did not see him in Washington. I talked to him at a banking meeting somewhere and visited with him about our proposition and just asked him what he thought the Board's reaction would be. And he also affirmed that if it were put to him, he would not recommend it.

Q. And why would they not recommend it? What was the problem with Worthen with reference to capitol ade-

quacy? A. We had experienced excellent growth through the years, over 15 percent compounded annually. The supervisory authorities require that you maintain a certain relationship between your capitol and your deposits. At each examination they had admonished us that our capitol ratios were not too strong.

We had been putting in anywhere from a million to a million and a half dollars new capitol. We had been restricting our dividend payout to less than 20 percent of our operating earnings for a number of years, and we had still not been able to put the capitol into the bank to support the growth that we had had in the last 15 years.

Q. Now with reference to your first proposal—that is, the sale of debentures—was there any objection to that proposal [217] from the state banking authority and if so, what was it? A. No. He didn't object to that. He said he would approve it conditioned on us having the right to repurchase the building at the end of 15 years.

Q. Was there also any problem with reference to any statutory limit on the amount of interest you could pay on the debentures? A. He called to our attention the fact we could only pay six percent under Arkansas law on debentures at that time.

Q. And what was the possibility—did you make any inquiry as to whether or not you could sell the debentures at six? A. We thought we could until we went to New York to try to sell them, and we came back and were told there was not any way we could sell them at six percent.

The market was at least one percent above that for banks our size and in our situation, and there wouldn't be any way we could sell the required number of debentures, $4 million in debentures, to fund this project on the basis on which we had anticipated doing it.

Q. So for both of those reasons what happened with reference to the first plan? Did you just abandon it? A. We just dropped it.

Q. And then proceded at once to submit—work out a second plan; is that correct? [218] A. Yes.

Q. Would you refer to Plaintiff's Exhibit No. 5 and just briefly summarize. Does that set out the second plan—proposed plan of financing? A. Yes. This sets out the plan of working out a sale and leaseback and in this letter mentions and that's the company we were in the most serious negotiations with at that time, outlining that we would hold on our books the maximum amount we could under the law because, again, that was the least expensive way for us to finance this building. Our cost of funds at that time was less than five percent.

So we wanted to hold the land and as much of any divisible or identifiable building we could. It turned out the way the building was drawn that the parking facility was as separate and as identifiable as we could get.

We planned to hold the land and the parking facility on our books: work out a sale and leaseback for the remainder of the building.

Q. And I believe that letter states near the top of page two that you would have the right to repurchase this building after 15 years at a previously agreed upon figure and the land at cost. A. Yes, sir.

Q. I believe you have already stated Mr. Adams had verbally told you prior to this letter that this would have to be [219] a requirement. A. The sale and leaseback, yes.

Q. They are the ones who proposed the fifteen year—option to purchase after 15 years? A. In conversations and when he later came back he put that in his letter.

Q. The second paragraph on page two reads: "We realize that the sale and leaseback arrangement may be slightly more expensive in the long run. However, we are of the opinion that the advantages it offers us are not tying down our capitol in land and building leaves us more lee-

way in the management of our bank and keeping our funds more profitably employed."

Would you expand on that just a little bit, Mr. Penick? Explain what you were driving at there. A. Well, as I mentioned, our cost of funds was about five percent. We realized we were going to have to pay more than that on whatever we could negotiate the best deal on the real estate loan on the sale and leaseback. Also, in order to maintain the proper ratios between capitol and deposits and capitol and loans, capitol and the amount invested in the real estate, that we felt like we could utilize the capitol we had in the bank rather than go out and try to acquire additional capitol.

We had gone back to our stockholders for a number of times, almost each year, for a million or a million and a half [220] dollars, and we didn't think we could continue to go back to them. So we wanted to finance this off our balance sheets.

The capitol we had would allow us to grow about, oh, $10, in deposits for each dollar of capitol. If we obligated that capitol on real estate, would compound our overall capitol problems.

Q. So by having less money invested in real estate, it would—for each dollar invested in capitol that's free, liquid capitol, that generates about how many dollars for lending purposes? Through increased deposits it allows you to— A. Well, that's economic theory. I have heard anywhere from six up to fifteen, but I would say you can go into the neighborhood of—

Q. But by keeping your capitol in a liquid position it did improve the profitability of the bank because you could better employ the capitol in the normal operation of the business: isn't that true? A. That's right, and to support our growth at that time and the anticipated growth we were looking forward to.

Q. What about the liquidity situation? How did the sale leaseback improve your liquidity problem? A. For each dollar of fixed assets in computing your liquidity they charge you $1 against your capitol, so it is very difficult in a growing bank to have enough capitol in it. [221] Once you've got the capitol in and have it maintained, it's a lot better to finance real esta'e projects such as this off your balance sheet.

Q. And are there certain regulatory authorities that require the bank to maintain a certain liquidity position? A. Yes, sir.

Q. And are there certain required capitol ratios that are affected by whether or not the building was financed on the bank's statement or off the bank's statement? A. As I mentioned, the capitol you have invested in the real estate for each dollar you invest in real estate you have to have a dollar capitol to support it. It's considered as a non-liquid asset and the last thing you can dispose of in computing a liquidity formula.

Q. Now I refer you to PX-2, Plaintiff's Exhibit No. 2. The one we have just been referring to was the letter you wrote to Mr. Adams dated September 1st.

Did you also write a letter containing the same plan to Mr. Wyrick, Plaintiff's Exhibit No. 2 also on September 1st? Will you refer to that? A. Yes, sir.

Q. I believe you outlined the plan by simply enclosing a copy of your letter to Mr. Wyrick and you pointed out you were presently negotiating with Goldman and Sachs to handle the sale and leaseback and enclosed some leasing brochures and [222] excerpts from the Landauer report. Then you asked him for his approval of this plan; is that correct? A. Yes, sir.

Q. And in response to that would you refer to Plaintiff's Exhibit 6 which, first, is the response from Mr. Adams. Again, would you briefly summarize that? A. Did you say Exhibit 6?

Q. Yes, Exhibit 6. A. Okay.

This is a letter from Mr. Harvill Adams, State Bank Commissioner, in response to my previous letter of September 21st in which he approves of the plan as outlined to finance as much of the building as we could on our statement and the balance on a sale and leaseback arrangement.

Q. And then on the sale and leaseback arrangement, referring to the last sentence, does he again repeat his requirement that you have an option to repurchase after 15 years? A. Yes. Quoting from his letter: "It is agreeable with this department with the understanding that you would have the right to repurchase this building after 15 years at agreed upon figure and the land at the cost at which it was, not to exceed, $965,000."

Q. Now, Mr. Penick, I would ask you, please, to refer next to Plaintiff's Exhibit No. 38 which, I believe, was your initial response from Mr. Wyrick to this second proposal. Would [223] you briefly summarize what he is requiring? First, I would ask you: Is this a memorandum of a telephone conversation you received—I mean you had with Mr. Wyrick on September 6, 1967? A. Yes.

Q. And you wrote this immediately following that telephone call? A. Yes, sir.

Q. Would you briefly state what it is that is worrying Mr. Wyrick with reference to this second proposal? A. The point he wanted to emphasize to me was that if it were going to be a clear sale and leaseback—in other words, if Goldman and Sachs, or other investors, were going to build the building and lease it to us, that he wouldn't have any hesitancy in approving that.

However, if we were going to borrow the seven and a half million dollars or to finance in any way the interim construction funds to any builder, that it could not be approved because it would run us over the $4 million we were allowed to put into the building without going to the Board of Governors. He just wanted to let me know that

even if we went through a third person—if we loaned the money on the interim construction or in any way put our money into it that went over the $4 million, we would have to go to the Board for approval.

Q. Now I will ask you to refer to Plaintiff's Exhibit No. 7, which is a letter to Mr. Adams, and state what it—[224] incidentally, did Mr. Wyrick also raise any question as to the handling of an allocation of architect fees and finance charges as consultant fees as between the Worthen Building and the garage? A. Yes. He wanted to be sure that we set that up separately on our books so we could account for what portion of it was chargeable to a part of the building Worthen was going to keep, what portion would be chargeable to the building that was going to be purchased by the investor.

Q. And would you just briefly summarize your letter to Mr. Adams dated September 12th? A. Again, it's the position we were in between two regulatory authorities trying to keep both informed as to what the other was doing. I don't know whether they were talking to one another.

But to inform Mr. Adams we had to revise the figures I previously furnished him as to architect fees, consultant fees, and others as directed by Mr. Wyrick since none of this would be allowed to be carried on our books. Just to keep Mr. Adams informed.

Q. Refer to Plaintiff's Exhibit 8 and state what Mr. Adams responded. A. He said: "I have your letter of September 12th in which you request several changes be made in the project cost of the parking garage, furniture and fixtures, and leasehold [225] improvements.

I have no objection to these changes and you are authorized to procede in accordance with your total project cost as presented to me in your letter of September 12."

Q. Now referring back to Plaintiff's Exhibit 3 which begins: "In line with our conversation . . ." this is a letter

to Mr. Wyrick following your conversation with him. You are explaining, first, that you will allocate the fees as he has requested; and, second, that in the second paragraph you will convey title to the land in which the bank office and building will be built to investors so that they will own the building and go on to state it won't at any time appear on your books.

Then refer to Plaintiff's Exhibit 4, which is a letter from Mr. Wyrick to you dated September 13 having received from you your letter of the 12th.

Would you just briefly—well, read the second and third paragraphs.

The Court: I will read those.

The Witness: He just summarizes that original proposal we had made to Mr. Adams with the admonition, again, that if we went over the $4 million we'd have to get approval of the Federal Reserve Board for any amount, whether it be interim financing to a third party investor in any way.

Q. Refer again to the last sentence and state if this is the type of admonition you had been receiving from regulatory [226] authorities for quite some time? A. He admonished us that the capitol account was not relatively strong and the directors are urged to review the bank's capitol position frequently.

The Court: All right. Mr. Williamson, I think we have gotten as much out of this day as we can. I know we have gotten more out of our reporter than we are entitled to. We are going to recess.

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[229] DIRECT EXAMINATION—Resumed

By Mr. Williamson:

Q. Mr. Penick, I believe your testimony closed yesterday at a point in which you had brought out that both Mr. Adams of the State Banking Department and Mr. Wyrick of the Federal Reserve in St. Louis had approved the second proposal of Worthen Bank involving the sale-leaseback arrangement for the purpose of providing the building. A. Yes sir.

Q. Following that approval, did you at first continue to negotiate with Goldman Sachs insofar as the sale-leaseback arrangement is concerned? A. We continued to negotiate with Goldman Sachs and a number of others including Stephens, Incorporated and Eastman Dillion; White, Weld.

Q. And would you state whether or not your negotiations with Goldman Sachs resulted in a tentative proposal from him? A. Yes.

Q. Would you refer to Plaintiff's Exhibit No. 9 and [230] state whether or not that is the proposal from Goldman Sachs—tentative proposal from Goldman Sachs?

Q. Then I believe you also just testified that you negotiated with—began negotiations with Eastman Dillion. Did they come up with a tentative—would you refer to Plaintiff's Exhibit 39. A. Yes, they came up with a tentative proposal.

Q. And that is a letter dated September 20, '67 to you from Eastman Dillion? A. Yes, sir.

Q. And that was their first proposal; is that correct? A. Yes.

Q. Then refer to Plaintiff's Exhibit No. 10. Now first the question: Was Eastman Dillion working in consort with any local investor? A. Not originally. They did later join with Stephens, Incorporated in a joint proposal. Initially, they were not.

Q. But even as of the date—if you will refer back to PX 39—even as of the date of September 20, they had associated Stephens, Inc. with them, had they not? A. Yes.

Q. Look at the first part of that. A. Yes, they had, but our initial contact with them, they did not involve Stephens.

Q. Referring to Plaintiff's Exhibit No. 10, did Eastman Dillion and Stephens, Inc. submit a revised proposal? [231] A. Yes, they did.

Q. And that was dated what date? A. October 27, '67.

Q. So at that time you had under active consideration proposals by both Goldman Sachs, Inc. and Eastern Dillion, Stephens, Inc. combined? A. Yes.

Q. Would you please state to the Court just how Frank Lyon Company became involved in these negotiations as you remember it? A. Frank Lyon Company came in very late. We were just about finalized down to one or the other of these two proposals. Mr. Lyon, who serves on Worthen Board, called me and asked did I have any objection or did he think it would be proper for him to make a proposal. He had not been familiar with the proposals of other companies since he was not—this negotiation was being handled by a finance committee for the building and Mr. Lyon was not familiar with that.

Q. He was not a member of that committee? A. He was not a member of that committee. I told him I thought it would be perfectly acceptable to me and I thought to the Board of Directors for him to submit a proposal and encouraged him to do so.

Q. So that we won't have to repeat the evidence that's [232] already been introduced, Plaintiff's Exhibit, PX 11, would you refer to that? That is the first proposal that Frank Lyon Company submitted to you? A. Yes.

Q. On the receipt would you refer to Plaintiff's Exhibit, PX 12? At that point then you had on the receipt of Frank Lyon's bid you had bids from Goldman Sachs, and Frank Lyon Company. What did you proceed to do with those three proposals? A. I didn't personally, but the finance committee chaired by Mr. Gates put the three proposals

side by each and compared the best part of each proposal to the best part of each other proposal. We then—some were better in some areas and other proposals were better in other areas, and we decided to pick the best part of each proposal and submit back to these three what we would like to have and say, "If you will meet these specifications we will go with you on it." So that was the basis on which our specifications were written because we picked the best of each of the three proposals.

Q. And those specifications are set forth in Plaintiff's Exhibit 12? A. Yes, sir.

Q. Before you leave Plaintiff's Exhibit 12——

The Court: I see. Yes. All right.

By Mr. Williamson:

[233] Q. Referring back to Plaintiff's Exhibit 12, you will note in the last line of the comparison or the last three lines, you compare the totals as of the end of the 15th year. Would you explain why you used the end of the 15th year in order to work out a comparison, taking into consideration the repurchase options and so forth. A. The State Bank Commissioner had required that we have the right to repurchase the building at the end of 15 years and that was in our requirement.

Q. And looking up there at the three on the repurchase options, the years available at which repurchases were included in the three proposals you then had to date, is it true that the 15th year is the only year in common—— A. That's right.

Q. —on which all three of them had an option to repurchase? A. Yes, sir.

Q. And consequently would you state whether or not that is the only year in which you could make a comparison of the three bids? A. Yes, that's right. That was the only year in which we did have figures on the repurchase from all three bidders.

Q. Then I believe there's been some testimony from Mr. Cotham yesterday that you had suggested to Frank Lyon Company that they consider submitting a joint bid with Stephens, [234] Inc. Would you state a little more in detail as to why you made that suggestion and did you make the same suggestion to Stevens? A. As I mentioned, we were pretty far down the road in our negotiations with Stevens that had been joined by Eastman Dillon and by Goldman Sachs, and we were about ready to try to resolve between these two when the Frank Lyon Company became interested in the proposal. Stevens, Incorporated is a good customer of the bank. Jack Stevens, the president of the firm, is a personal friend, and we wanted to retain the business of both Stevens and also the Frank Lyon Company.

Mr. Lyon is in the same position: a good customer of the bank, a director and a friend. It is my responsibility and our responsibility, however, to get the best deal for the bank regardless of that and we were trying to do a little public relations work and get those two to join together and each take a part of this deal.

Q. Did you also suggest to Stevens that they consider a joint bid? A. Yes, sir.

Q. Would you state to the Court what the reaction of both parties was? A. The reaction of both parties was, "We don't need the other." Evidently, it was not such an attractive deal that [235] split down the middle it would have been attractive to either party. Half of it wasn't big enough for Stephens and, evidently, half of it was not attractive to the Frank Lyon Company. Neither one felt like it would be to their advantage to join with the other.

Q. So what happened then when you submitted the specifications for sale and leaseback to Stephens and Frank Lyon Company? A. And also Goldman Sachs. Goldman came back in a telephone conversation and said they had made their best proposal to us. Stephens, Incorporated came back and said they couldn't—weren't interested in

changing their previous proposal and wouldn't meet the specifications that we had set out in our agreement. And Frank Lyon Company came back with a letter that said they would meet it and reduce the rent $21,000.00 a year.

Q. Now while we are on the $21,000.00 a year, would you proceed to explain—now that was a proposal November 1 of 1967, was it not? A. Yes.

Q. The bank building—and it was based on this proposal that the parties proceeded to negotiate for some six months before coming up with the final document which the evidence has shown were executed about mid-May of 1968.

When was the bank building completed and first [236] occupied? A. About December of 1969.

Q. So the question of the payment of the reduction of the rent by $21,000.00 did not become a material factor until the rent began; is that true? A. That's right.

Q. In the meantime, was any proposal made in connection with the building lease to fix a rent at $21,000.00 less than the amount required to amortize the note? A. That was in the original proposal when——

Q. What was the reaction of New York Life to that? A. New York Life would not accept it. They would not accept any less payment less than that necessary to amortize their loan.

Q. And those documents were executed in May of 1968 I believe. A. Yes, sir.

Q. And nothing more was said about the $21,000.00 until what happened? A. No, at the time that we were not able to handle it as a reduction of the lease it was acknowledged by the Frank Lyon Company as an obligation to Worthen Bank to be repaid over a five year period in some form or fashion, but originally structured as a rental reduction. When that was not allowed, it was still acknowledged as an obligation from [237] Frank Lyon Company to Worthen Bank.

Q. Then would you follow on through as to what happened with reference to the $21,000.00? A. Well, in August when the Frank Lyon Company borrowed the $500,000.00 to make the down payment on the Coca Cola Company, I believe it was Dick Gates that came up with the idea of charging Frank Lyon Company a rate of interest over and above what the prime rate at which they borrowed sufficient for us to gain the $21,000.00 the Frank Lyon Company would owe us for the first year of the five year period.

Q. Do you remember what the rate of interest was? A. No, I don't. I think it was nine and a half percent.

Mr. Williamson: Your Honor, somewhere here I have a copy of the bank's ledger reflecting the loan and reflects the rate to be nine and a half. I'd like him to be certain on that. I will move on to another point.

The Court: Very well.

By Mr. Williamson:

Q. What has happened in the meantime, Mr. Penick, to interest rates? A. They have gone up to a prime rate of 12 percent.

Q. At the time the Coca Cola loan was made, you were loaning money to Frank Lyon normally at what rate then? [238] A. At the prime rate, it was probably six or six and a half.

Q. Has the $21,000.00 obligation which converted into five year reduction of rent would be a hundred and five thousand dollars, has that been completely discharged to date? A. No. Only less than a fifth of it.

Q. Does Worthen Bank still consider this an obligation of Frank Lyon? A. Frank Lyon Company, yes, sir.

Q. And will you see that its is paid? A. Yes, sir.

Q. In some form or other? A. Yes, sir.

Q. To refresh your memory on the rate of interest that was charged on the Coca Cola loan, I believe this is the $500,000.00. A. This is the date of the note.

Q. Well, I thought I had—here it is.

On August 21 this is the first entry on the $500,000.00. A. Yes, sir.

Q. This is a copy of your ledger on Frank Lyon—Worthen Bank ledger on Frank Lyon Company? A. Yes, sir.

Q. What was the rate of interest that was charged on [239] that $500,000.00 note dated August 21, '69? A. Nine and a half percent.

Q. Just glancing at this ledger since we have it, what was the balance, total liability, of Frank Lyon Company to Worthen Bank—well, at any date throughout '69? That liability was running about what? A. Over $2 million. On August the 20th of 1969, was $2,023,078.44. That was transferred to this sheet.

Q. Pick another date as of the end of '69, what was the amount owed Worthen Bank? A. A million four hundred fifteen thousand five seventy-eight on October 6 of '69. January the fifth of '70 would be as close to the end of '69 is a million four hundred three thousand seventy-eight and forty-four cents.

Q. Take the last one on the page. January 6, 1971, how much was owed? A. A million two hundred seventy-five thousand.

Q. All the way through, Frank Lyon owes considerably in excess of a million dollars, do they not? A. Yes, sir.

Q. I believe it's already been brought out that tentative commitments had been made by First National City Bank and by New York Life Insurance Company for interim financing and permanent financing to an investor; is this true? [240] A. Yes, sir.

Q. And can you state who had made those tentative arrangements? A. Well, it was only natural for us to make those arrangements ourselves. The First National City Bank of New York is our principal—or was at that time our principal New York correspondent bank. We were

in daily contact with the principal officers of that bank. We were talking about borrowing $7.5 million. That would be the natural place that we would go.

We were also—my father was a long time personal friend of Mr. Dudley Dowell, who was the president of New York Life. We had done a number of other financing projects for New York Life in Arkansas. It was only natural that we would go to New York Life Insurance Company to talk with them about the mortgage on our building.

And on the trip to New York, we made the contact with Mr. Dowell and he brought in real estate people and also with the top people in the First National City Bank, at which time we got variabble commitments on both the interim financing at the National City Bank of New York prime rate which was a real concession to us.

I don't think any other borrower just walking in off the street would have gotten prime rate loan on an interim construction project. Then we got a verbal commitment from [241] the New York Life Insurance Company for a permanent loan subject to an acceptable investor to them being submitted which would have to be substantiated on its books.

Q. So would you state whether or not it was to Worthen Bank's advantage using your own connections to arrange for interim and permanent financing? A. It was to our advantage from the interest rate standpoint to arrange that. It was to our advantage to use our contacts so we could keep to a minimum the fees and other costs that are normally incidental to this type of financing. We realized in the long run we were going to have to pay for it one way or the other, so we wanted to keep our cost down to a minimum.

Q. And you would have to pay for it through it in the form of rents—— A. Yes.

Q. —That would be required to amortize the loan; is that correct? A. Yes.

Q. Would you refer to Plaintiff's Exhibit No. 16. This appears to be the commitment letter from First National City Bank addressed to Edward M. Penick, obligating First National City Bank to make an interim loan of $7 million to "a mutually acceptable real estate corporation."

This is the written commitment of First National City Bank for the interim financing? [242] A. Yes, sir.

Q. And I believe from Plaintiff's Exhibit No. 17 that commitment letter was, in fact, addressed to Frank Lyon Company, the commitment letter on the permanent loan from New York Life. A. Yes.

Q. Mr. Penick, were you in the courtroom yesterday and heard testimony of Ralph Cotham with reference to the extended—and Mr. Darrell Dover with reference to the extended negotiations to work out all of the documents involved in this transaction? A. Yes, sir.

Q. You were aware, were you not, these were going on? A. Yes, sir.

Q. Did you participate in any of the discussions? A. In some of them, but not on a day-to-day basis.

Q. Only those that involved some final decision on the part of the bank? A. Yes.

Q. Did you participate in those? A. Yes.

Q. Would you state whether or not the documents were, in your opinion, the result of arms-length negotiations and bargaining? A. Yes, they were. Very tough bargaining on the part [243] of all parties involved in it.

Q. After the documents were worked out and about in final form, was there any requirement from New York Life that the form of the transaction in its final form be resubmitted to the bank regulatory authorities for their approval? A. They required that after everything was agreed on before any money was disbursed that they finally approve the actual document.

Q. Would you refer to Plaintiff's Exhibit No. 40 and describe briefly what that it? A. This is a letter from me

to Mr. H. C. Adams, State Bank Commissioner of the State of Arkansas, regarding the construction of the Worthen Bank Building.

Q. Would you read just the first paragraph of it? A. "I have previously discussed with you and you have previously indicated your approval of the sale and leaseback arrangement for the financing of our new bank building. However, attorneys for New York Life Insurance Company, the permanent lender, and the First National City Bank of New York, the construction lender, have requested that Worthen Bank and Trust Company obtain formal approval by the State Bank Commissioner of the consummation of the transaction involved in the construction of our new bank and office building."

Q. And then follows three pages describing in detail exactly what is going to be involved in the transaction; is [244] that correct? A. Yes, sir.

Q. And then the final paragraph on page four, "You are requesting"—would you just read that? A. "Since your approval of the foregoing is being required by First National City Bank to close the construction loan, we would greatly appreciate hearing from you at your earliest convenience."

Q. Then refer to Plaintiff's Exhibit 41. A. "By way of interest he endorses on the letter, "The plan of financing your building as outlined in this letter has been approved." Signed by Mr. Adams.

Q. Right.

Then refer, please, to Plaintiff's Exhibit 41, which appears to be the identical letter you wrote to Mr. Adams which was addressed to Mr. Wyrick; was that true? A. Yes, sir.

Q. Also referring to the last page of that letter, Mr. Wyrick expressed his approval on what date? A. April 23, 1968.

Q. However, before doing so, was there some further correspondence with Mr. Wyrick? Refer first to Plaintiff's

Exhibit 42. I call your attention to the fact that your letter to Mr. Wyrick was dated April 16.

On April 19 he wrote you a letter raising what [245] questions with reference to the transaction? Would you just read that letter? A. This is a letter from Mr. O. O. Wyrick, vice-president of the Federal Reserve Bank of St. Louis addressed to me.

"This refers to your letter of April 16, 1968, regarding interim and permanent financing for the new bank building under construction and requesting our approval of the program outlined in your letter.

"On the basis of previous understandings that the bank's investment in bank premises will not exceed its capital stock, my letter of September 13, 1967, advised that the proposed new building project would not require prior approval under the provisions of Section 24A of the Federal Reserve Act of the Board of Governors of the Federal Reserve System. At that time it was understood that the bank would have no financial interest in the building and would furnish none of the funds for its construction.

"Your letter of April 16, 1968, indicates that Frank Lyon Company shall arrange for the construction loan. In order that we may be in a position to execute the approval requested in your letter, the following information is required:

"Number one, please advise us as to the present carrying or book value of all bank premises, all offces, including leasehold improvements.

"Number two, caption or title and present balance in 'construction account'.

[246] "Number three, a projection as to the highest amount construction account will reach before the bank is reimbursed by the Frank Lyon Company.

"Four, your assurance of that the book value of the bank premises plus the balance at any time in the construction account will not exceed the bank's capital stock.

"Upon the receipt of this information and assurances we will be in a position to act upon your request."

Q. Following that letter—referring now to Plaintiff's Exhibit 43—what was Worthen Bank's response? You don't have to read it if you are familiar with the contents. You can just paraphrase it, saving time. A. I assured him we would not at any time have more than $4 million carried on our books in the construction account; that the Frank Lyon Company would purchase the building as it was being built and we would not build the building and sell it to Frank Lyon Company after completion.

Q. Then following receipt of that letter—referring to Plaintiff's Exhibit 44—what was Mr. Wyrick's response? A. He granted his approval to the financing plan we had outlined in our previous letter of April 19.

Q. And it was with this letter of April 23 that he returned to you your original letter to him dated April 16—— A. Yes.

Q. —the last page of which he executed his agreement [247] of the financing plan; is that correct? A. Yes, it is.

The Court: His requirement then, I gather, was the basis for the decision to transfer, in effect, the title on a brick-by-brick basis during the course of the construction to keep the total not to exceed the limitation of $4 million?

The Witness: Yes, sir.

By Mr. Williamson:

Q. And had he made that quite clear to you even preceding October? A. In telephone calls and in personal conferences.

Q. And this was prior to the drawing up of the documents and, consequently, resulted in the piece-by-piece sale? A. Yes, sir.

Q. Mr. Penick, would you comment generally on who first established the overall nature of the transaction as a sale leaseback transaction? A. We—Worthen Bank established it as the most logical way and the best way financially from our standpoint to finance our new building.

Q. You have already testified that you first proposed that you own it through a wholly-owned subsidiary. A. Yes, sir.

Q. But that was not permitted, ruled out by the bank [248] regulatory authorities; is that correct? A. Yes.

Q. In establishing the overall transaction as a sale leaseback transaction, was Worthen Bank—would you state whether or not Worthen Bank was motivated by any tax consideration in reaching that determination? A. Well, I think tax considerations have a part in any business judgment. They certainly weren't the motivating force but we certainly wanted to know what the tax consequences were of the ownership of a $9 million building.

Q. Would you refer, please, to Plaintiff's Exhibit 45. This purports to be a comparison of the annual rent for the first three years of the lease, the comparison of the annual rent that Worthen was paying and for which it would get a deduction in its tax return, with a depreciation schedule on a straight-line basis and an interest deduction which Worthen would have got had it owned and financed the building.

Would you state at what—what does that reflect as far as the advantages of ownership, the tax advantages of ownership would have resulted in advantage to Worthen over what period of time? A. The first-up through 1977 it would have been more advantageous for Worthen to own the building themselves. The depreciation and interest would have been slightly in excess of the rent.

[249] After 1977—and the schedule only goes through 1979—it turned around and it would have been——

Q. Had the schedule been extended, these would have been increasing amounts? A. Increasingly larger, yes, sir.

Q. Now I note that this schedule was prepared on a straight-line basis. Had Worthen elected double declining balance, it would have gotten a greater—state what would have been the effect of a double declining balance method of depreciation. A. The advantage would have been more.

Q. In the earlier years? A. In the earlier years. The first seven or eight years.

Q. In the later years would that have been washed out by taxable income? A. Yes.

Q. But basically the reason I believe your testimony has already made clear that the reason that this particular form of transaction, a sale leaseback was chosen was not dictated by tax motivation. A. No, it was dictated by the economics of good business judgment, the best use of our capital and what we would be authorized to do by the bank regulatory authorities.

Q. And, in fact——

[250] The Court: Let's see. By the time the plaintiff company entered the picture, you had rejected other alternatives and you were down to a format of a sale leaseback?

The Witness: Yes, sir.

The Court: At that point, as I understand it, an investor had no choice in the sense of establishing his arrangement with you. He could bid, in effect, in terms of that format only?

The Witness: Yes, sir.

The Court: So the Frank Lyon Company had nothing to do with the establishment of the arrangement, the form of the arrangement.

The Witness: Had nothing whatsoever to do. We were, I'd say, within two weeks of making a decision between the

sale and leaseback proposals we had on hand at the time the Frank Lyon Company became interested.

The Court: Now let me ask you, Mr. Penick: Although on a pure dollar-by-dollar basis, I think you have said it probably would be the most economical way for the bank to do it out of its own resources on a straight basis. On an overall basis, considering the use of your capital for banking purposes and for the success of the enterprise, did you determine that was advantageous ultimately to go this route in order to keep as much capital released as possible?

The Witness: Yes, sir. We had been—every time [251] we'd have an examination we'd have in the last paragraph, as I mentioned, a letter from the supervisory authorities admonishing us that our growth had put continued pressures on our capital account and we should be aware of it and doing everything we could to continue to build the capital account.

We could not do that by trying to put this large a project on our books in the form of real estate, which would be a direct charge against capital.

The Court: All right.

By Mr. Williamson:

Q. Mr. Penick, would you please state then what was Worthen's intention with reference to Frank Lyon Company vis-a-vis, who would own the building between Frank Lyon and Worthen? A. Our intentions were to make the best deal for the Worthen Bank and I'm sure Mr. Lyon and his organization was working to make the best deal for the Frank Lyon Company. Our negotiations with the Frank Lyon Company were completely at arms-length.

Q. And insofar as the ownership of the building is concerned, what was the intention of Worthen Bank? A. Well, the intention of Worthen Bank—we could not own the building. It was our intention, however, in our discus-

sions with any prospective investor, we wanted to make [252] it clear we wanted to control the design of the building, the name of the building, the type of tenant improvements that went into the building. Everything to do, we wanted complete and exclusive control on the image of Worthen Bank as expressed by our building. We didn't want to get anybody's approval on whether to use brick or precast concrete or structural steel.

We had in mind the type of structure we wanted to build and we wanted an investor that was agreeable for us to make those decisions.

Q. Is that not the principal reason for every sale leaseback in which the owner constructs and then sells in order that he can get the type of building he wants? A. I think it's a primary consideration, yes. It was very important to us, however, in this circumstances because we were building an image-type of building for a large financial institution.

Q. But merely because you designed the building—did you employ the contractor? A. Yes.

Q. And the architect? A. Yes, sir.

Q. And Mr. Morse. What was his role, incidentally? Who was he, by the way? A. Mr. Carl Morse is a building consultant from New [253] York City. I mentioned earlier that we had counseled with the officials at the First National Bank of Memphis in their experience in building a building. Mr. Norfleet Turner, who at that time was president of the First National Bank of Memphis, said the first thing I should do as the president of a bank or any group that's getting ready to build a building, said, "Go to New York and hire Carl Morse. He will save you more money. You don't have time to look after the contractor and builder and he will save you more money than you could imagine."

So I did that and hired Mr. Morse. And he did exactly what he said he would do. He controlled the building of the building.

I believe I mentioned earlier that we were building under what to us was a new type of project or program. Rather than have fixed bids, we were building against a budget, and Mr. Morse negotiated the budget items with the contractor and the subs. And on major items, he bought those items himself, like he expressed in the purchase of the elevators. We had eleven elevators and he said, "I'm buying a hundred fifty for other buildings and I will put your eleven in and see if we can better bid," and he saved us a hundred and some odd thousand dollars on our elevator bid. And there were a number of projects of that type.

Q. And Worthen Bank did employ him? [254] A. Yes, sir.

Q. I believe you have stated it was your intention that Frank Lyon Company own the building and was this—I beilieve it is quite clear from the documents that this was a requirement of the regulatory authorities, both state and federal. Is this correct? A. It was not a requirement that the Frank Lyon Company own the building. It was a requirement that——

Q. That you not own the building? A. ——that we not own the building.

Q. Would you please state who the borrower was with reference to the interim financing? A. Frank Lyon Company.

Q. Was this the intent of Worthen Bank? A. Yes, sir.

Q. Who was the borrower as far as the permanent loan is concerned? A. The Frank Lyon Company.

Q. Again, from your point of view, was this the intent of the Worthen Bank? A. Yes, sir.

The Court: All of your intents, so to speak, in this respect are independent of who the investor is. In other words, it would have been the same had it been Goldman Sachs or Dillon or anybody else?

[255] The Witness: Yes, sir.

The Court: And your objectives were dictated, as I understand it, principally by regulatory agencies and your own attitude as to the use of your capital and had nothing to do with the investor's objectives or his intent, so to speak?

The Witness: Yes, sir.

By Mr. Williamson:

Q. Mr. Penick, it appears that one of the contentions of the government is that Frank Lyon Company was a mere strawman in this situation. Would you please comment on that?

Mr. Sayre: Excuse me, Your Honor. I object to the general question as to form. If he has a specific question about the nature of the relationship he can ask him, but just not to make a general speech or comment on something.

The Court: Well, I am going to overrule the objection. The case is being tried to the Court. Sometimes you can shorten the procedure. I think it is obvious what the attorney is getting at.

You may answer.

The Witness: It was not our concern who owned the building: whether it was the Frank Lyon Company or one of the other successful bidders. Our principal intention and our motivation was to build the building at the least cost to the bank and the most effective and efficient manner.

It so happened that the Frank Lyon Company was the [256] successful investor that convinced us they could do that for us.

By Mr. Williamson:

Q. Now in your opinion would you state whether or not this whole transaction was a sham? A. Under no circum-

stances was it a sham. It was a long, well thought out, well developed financing of this building and in no way was there anything of that nature ever entered into any of the discussions or negotiations. They were all on a business-like basis completely, each party representing the best interest of their company.

Q. If the bank regulatory authorities were demanding that Worthen Bank not own the building, would Worthen Bank have been a party to a transaction if the purpose of it was a mere sham to put legal title only but not ownership in Frank Lyon Company? A. We would have had no part of it.

Q. Another contention of the government in this case is that Frank Lyon did not make a $500,000.00 equity—initial equity investment in this building but loaned the $500,000.00 to Worthen Bank.

Would you comment on that? A. That's a theory that I can't follow. I don't see how you could come up with that theory accountingwise or economicwise or taxwise.

[257] Q. Is Worthen Bank——

The Court: Let me ask you just a moment. I just haven't had the time to go over the comparisons of the proposals such as you made in one of—or had made in one of these exhibits.

Under any of these proposals would the investor have had to put up a certain amount of their resources.

The Witness: In each case there was a requirement for equity.

The Court: Let's see if we can find——

The Witness: In our specifications we specified what we would pay.

The Court: Look at Plaintiff's Exhibit 12. How is there anything in there that will show me what the investor in each case was thinking about putting up in terms of its own resources?

The Witness: Well, it will in the specifications on 13. The first specification: Equity be supplied by the investor. We required $500,000.00 and we agreed to pay them an annual rental at the rate of six percent.

The Court: Is there anything in their proposals or prior discussions or negotiations or letters—that is, I am thinking about other than Frank Lyon—which indicated roughly the equities, so to speak, that the investor was contemplating putting in?

[258] The Witness: I can't put my hand on exactly what exhibit, but in one exhibit there are laid out side by side in which I believe the Stephens proposal was to put in $384,000.00 in equity. Goldman Sachs was to put in a similar amount, I believe.

The Court: Maybe Mr. Williamson can help us. Can you draw my attention to any preliminary negotiations, letters, comments, which indicated the investment which the others were thinking about putting in in this preliminary stage?

Mr. Williamson: Your Honor, it is summarized on page 12.

The Court: I was just looking at that. Then it is the next comparison.

Mr. Williamson: Exhibit 15. Your Honor, shows—now it does not show Goldman Sachs. That does not appear.

The Court. I just want to get some idea.

Mr. Williamson: Look on Exhibit 15, the second line "investor equity". Syephenshad proposed to put in three hundred and sixty thousand. Lyon's first proposal was to put in eight hundred and sixty thousand. Worthen had sort of split the difference in its specifications and came up with five hundred thousand, and Lyon's second bid was for five hundred thousand to meet the specification.

The Court: Now in terms of what the controversy [259] over the use of the word "interest" and in your Exhibit 13 the use of the term "rate" in this comparison made on November 2, in the preliminary negotiations, say, with Stephens, did they make a point, in effect, as to what their minimum return on—if they are going to get into this—would be in the sense as to some sort of a rate? Does six percent we find under Stephens, did that come from Stephens' proposal?

The Witness: No, one of them was six and three-quarters.

By Mr. Williamson:

Q. That was Frank Lyon's first proposal? A. One was six and three-quarters and I believe the other two were six.

The Court: But they had it in their proposal?

The Witness: Yes. It is in the exhibit someplace.

The Court: That's all right.

Now as I understand it, in order to get an investor you have to have a package which theoretically is attractive——

The Witness: Yes, sir.

The Court: —is able to attract the investor, something that any investor might be wanting to get into and he has to look at it from two or three aspects, as I gather an investor would: what is the maximum potential I [260] might make out of this under any circumstances on the one extreme, and what is the very least I will make or lose if I enter this transaction.

Now am I correct then in terms of any of these proposals that each would have been required to put up some equity of his own?

The Witness: Yes, sir.

The Court: And Worthen was in a position, in effect, to assure them that at the very least they are going to get, in effect, at that time, I guess, a fair return on their equity?

The Witness: Yes, sir.

The Court: Is that correct?

The Witness: Six percent is what we proposed. In some of the proposals they asked for six and three-quarters.

The Court: And then you go from that, I gather, and say, "Yes", but, of course, you have other advantages depending upon how you can use the depreciation in your own business and depending upon our future decisions, and you may go from this so-called minimum which we more or less guarantee return to progressively very substantial returns on your equity investment, so to speak. Is that the way you approached these people regardless of who they are?

The Witness: Well, yes. I think at the time they were in a little different money situation than we are now in. [261] Many of these firms were seeking this type of investment.

They would be representing maybe other investors or they would divide the investment up, but in money circumstances in 1967 and 1968, this type of investment from investment companies was very much sought after as indicated by the number of companies that came to us when they heard that we were planning a new building.

As I mentioned earlier, we didn't have to do much selling but ferret out the better proposition for ourselves. We had a number of ways we could have gone, a number of companies that wanted to build this building for us.

The Court: All right.

By Mr. Williamson:

Q. Mr. Penick, to follow up on Judge Eisele's line of questioning, in your specifications the first requirement is

that the investor put up $500,000.00 in equity and he could expect an annual rate of return of six percent on that. A. Yes, sir.

Q. That was translated, and as the Judge properly pointed out, that was the minimum that he would make.

Now that was translated into the option prices, is it not—— A. Yes, sir.

Q. —so that if Worthen exercised its option at the end of the 11th year, this is what the investor would have [262] gotten back and this helped establish the—— A. Option price.

Q. —option price. Now——

The Court: And that is the basis for the government theory that you should treat this as a loan and the option will be exercised and that this is the interest, as they say, the investor would get upon his loan.

The Witness: Yes.

The Court: That's the basis for their contentions in that regard.

By Mr. Williamson:

Q. But—and we'll come back to whether or not Worthen is going to exercise that option.

You have stated you did not understand that Frank Lyon Company had borrowed the $500,000.00. Has Worthen ever executed a note? A. Excuse me. I didn't understand.

Q. You stated you did not understand how the government could contend that Worthen had borrowed $500,000.00 from Frank Lyon Company. A. Yes, sir.

Q. Have you ever executed a note to Frank Lyon Company? A. No, sir.

Q. Is Worthen Bank obligated to pay Frank Lyon Company [263] the $500,000.00? A. No, sir.

Q. Is it obligated to exercise its option? A. No, sir. The option all runs all our way.

Q. Is there any way Frank Lyon Company will ever get any repayment of its initial equity in the investment other than through the exercise of the option? A. Only to the end of the 25 years. The equity is building up as the payments are being made. That will——

Q. But if Worthen Bank never exercised its option, will Frank Lyon Company ever be repaid the $500,000.00? A. No.

The Court: Just before we leave it, are there any unwritten agreements or informal understandings of any kind or nature that Worthen will, in fact, exercise any of these options at a given time?

The Witness: No, sir, there's never been any discussion of the intention of the parties as it relates to the option.

The Court: Has such intentions at this time been formed? Has the company made a decision as to what it is going to do?

The Witness: No, sir, we have no decision. I have some information which would be very important as to that type of decision, but we have made no decision on it.

[264] The Court: Ultimately, the decision will be made at the time it should be made on the basis of all facts and circumstances before you at that time.

The Witness: We have just completed in August of this year—we retained the First National City Bank of New York, Corporate Finance Division, to make a study of the capital needs of the First Arkansas Bank Stock Corporation, FABCO, to determine what our capital needs will be over the next five years and the first page of the report, about the fourth paragraph, said that Worthen Bank will require approximately $7.5 million in long-term capital debt over the forecast period in addition to the recent equity infusion. We have added $5 million to the capital

structure of Worthen within the last two years at the insistence of the Federal Reserve System.

This study shows that if our growth continues at the rate it's been going over the next five years, to keep up we will have to put in another $7.5 million. We don't see any way we could entertain even the idea of exercising this option with five and a half million coming out of capital to put in negotiated assets.

If we had to make the decision today we could not exercise the option.

The Court: In other words, on the basis of that report, you'd need more than $12.5 million?

[265] The Witness: Yes, sir.

The Court: Now in terms of your past experience, do you usually get this from your stockholders by preemptive rights or how have you been doing it?

The Witness: Well, up until the time Worthen became a part of First Arkansas Bank Stock Corporation, we did have preemptive rights and went back to the stockholders year after year. When we organized the holding company, the stock went in there and the holding company has furnished the capital to Worthen and has furnished the $5 million of capital over the last two years as required by the Federal Reserve Board.

By Mr. Williamson:

Q. Following up on that line of questioning, Mr. Penick, what is Worthen's present capital stock? A. $10 million.

Q. Do you know what its present investment in bank premises is? A. Total of about nine million.

Q. Do you happen to have a current financial statement with you? A. I have a September 30, the last published statement.

Q. Look at that statement and see what the total investment in bank premises is. Isn't it somewhat more than nine million? A. Nine million, eight hundred eighty thousand.

[266] Q. So that as of right now—and this investment has arisen through more branches, that sort of thing? A. Yes, sir. Through more branches and the Worthen Bank purchased the old Blass building, which we are in the process of remodeling as an operations center.

Q. So right now Worthen Bank is just bumping at its limit on investment in bank premises? A. Yes, sir.

Q. And referring back to that City Corp. report, did you explain to the Court just who City Corp. is, who made that study? A. This is a financial consulting section of the First National City Bank of New York.

Q. And that report stated that Worthen would have to raise an additional $7.5 million new capital by what time? A. Over the next five years.

Q. Now Worthen's first option is at the end of the 11th year on November 30, 1980. Will you state whether or not in your opinion that option will be exercised in view of the capital requirement of Worthen? A. My opinion today is it will not be, and could not be under our current situation.

Q. Under current situations and the forecast of City Corp., in your opinion would the bank regulatory authorities permit Worthen to invest another six million option price at [267] the end of 11 years of something in excess of $6 million? Would the regulatory authorities permit Worthen to exercise the option? A. No, sir.

Q. Let's turn on to the subsequent option period.

There is an option Worthen will have, an option at the end of 15 years, to buy the property for $5,432,600.00; at the end of 20 years to buy it for $4,187,000.00.

Can you at this time state whether or not in your opinion Worthen will exercise either of those options? A. In my opinion at this time they would not.

Q. And would you state why? A. Well, the building is financed and we are comfortable with the financing. We

have an excellent rate of rental payment. The problem that we face is raising capital to support growth, not raising capital to refinance a building.

Also, I don't believe that if we elected to exercise our option—I think we must exercise the option out of retained earnings. I don't believe we have any right to assume the mortgage. In today's interest rate structure, you would be looking at swapping a six and three-quarter percent mortgage for probably a ten and a half percent mortgage, and it just doesn't make good business sense.

Q. At the end of 25 years there is an option to—Worthen Bank will have the option to exercise at a purchase [268] price of $2,145,935.00. Can you state whether or not at this time it is possible to determine that you will exercise that option? A. In my opinion today I don't think we would exercise the option.

Q. Again, for the same reasons you have just given with reference to unlikelihood of exercising the option at the end of the 15th, 20th and now the 25th year? A. Well, the rental drops and then the rental on the—the difference in the rental on the land and the building we'd be living in it in a very, very cheap price.

Q. Would you please explain that to the Court? At the end of the 25th year you will have the choice of either exercising the option or buying the building for $2,145,935.00 or continuing to rent for a period of 40 years, I believe, at what net rentals? A. I'd have to refer to some schedule. I think a net rental the first year is about $300,000.00. The first five years.

Q. Well, to refresh your memory, let's refer now to Plaintiff's Exhibit 46. Let's talk about Section 1 of that exhibit.

You would have an option to purchase the building in 1994 for $2,145,935.00. As of the date you went into this operation and according to the City Corp. report for the

period [269] 1969 through 1973, what average return on capital was Worthen earning? A. Ten point one.

Q. If you were still earning ten point one on capital in 1994 and had an option either to keep this two million one forty-five working in the normal functions of the bank or to invest it in real estate, and you chose not to invest in real estate, at your annual return of capital of ten point one, what return could you expect over the next 40 years, gross return, on that $2,145,000.00? A. We could return $216,739.00 or a total over the 40 years of $8,669,560.00.

Q. Now turning to Section 2 of that Plaintiff's Exhibit 46, to refresh your memory, the building lease following the 25 years, the annual rental was to be $300,000.00 a year. However, Worthen had leased the ground to Worthen Bank for a period of 75 years. Now the first 25 years—the testimony has been brought out earlier that the first 25 years the rent was only $50.00 a year. Would you please state whether there is any significance to that $50.00? A. Well, the $50.00, we were just running the expense up on ourselves. If we had charged a going market rate of $100,000.00 a year for the rent on the land, the owner of the building would have rolled that right into our cost of rent in the building and it would just run the cost up on ourselves. [270] We had the investment in the land and we elected to leave it at a minimum rent.

Q. So it made no difference during the first 25 years what the rent was. A. That's right.

Q. It could have been $50.00 or $500,000.00 and it would have washed out because it would have been fed right back on Worthen.

Now during the second—after the 25 years, though, it's been brought out through bargaining that Worthen was able to establish a ground rent under your ground lease of a hundred thousand a year for the first five years. Now if your rental was three hundred thousand that you had to pay under the building lease to Frank Lyon Company and

Frank Lyon Company, in turn, had to pay you a hundred thousand under the ground lease that would have resulted in a net rental expense to Worthen Bank for the first five years of what amount? A. $200,000.00 a year, a million dollars over the first five year period.

Q. And for the next five year period the rental, ground rent, went up to a hundred fifty thousand dollars a year, which resulted in a net rent cost—the $300,000.00 building lease resulted in a net rental cost to Worthen of how much? A. A hundred fifty thousand dollars a year or $750,000.00. [271] Q. For that five years? A. For that five years.

Q. Likewise, the rent, the ground rent, went up to two hundred thousand resulting in a net rental to Worthen of what? A. hundred thousand dollars a year or $500,000.00 for the five years.

Q. And for the last 25 years your rent, the ground lease rent, stays at two hundred fifty thousand, and the building rent stays at three hundred fifty thousand, so the net rental expense to Worthen is how much? A. $50,000.00 a year for 25 years, or a million, two hundred fifty.

Q. So if you elected at the end of 25 years not to exercise your option, you could look forward to a gross rental expense or a net rental expense over the next 40 years of how much? A. $3.5 million.

Q. So comparing what you could earn on your two million one forty-five, if not put into the building with what your rental expense would be, what would be the net gross economic effect as far as Worthen is concerned? A. It would be to our advantage by $5,169,560.00 to continue as a tenant and not to exercise the option.

Q. Now with that much spread between the two choices [272] you would have, that much economic advantage in not exercising, would you state whether or not your return on equity, your average return on capital, suppose it fell from ten percent down to seven percent, would it still be to Worthen's advantage economically not to exercise the option? A. Yes, sir.

Q. Referring back, you have already commented on it would not perhaps be the best economic use of Worthen's capital to invest in exercising the option after 15 years and put another five thousand four hundred thirty-two thousand in bank premises. Would you estimate whether or not at the end of 15 years the bank would be in a position to do so without exceeding its capital requirements? A. I would think that we would have the capital available. We could do it, but under the regulations—but I don't think it would be the best use of our capital.

Q. Would you comment on—again, as of the end of the 25 years, would you comment on whether or not from physical and functional point of view, Worthen Bank's view of that building from a physical and functional point of view, whether or not it would be a good buy at $2,145,000.00. A. I think that probably at the end of that time it would be a good buy at $2,145,000.00, but if you look at the lifetime of a bank building, the building for some use other than a bank would probably be worth that. But if you look in [273] the lifetime of this bank, how many times it's moved, and it's almost hundred year history, 25 years is about the maximum it can stay in any one place in a functional building.

We moved at Fourth and Main in 1929 and we stayed there a little over 25 years. We shouldn't have. I think we should have moved at the end of about 20 years, but the nature of the business is changing very, very rapidly. It's going to electronic funds transfer positions.

The need for a major office building of that type is becoming less and less and just the changes in the industry could indicate that this building would be obsolete as a headquarters for a banking building.

The Court: In other words, you are talking about the effects in terms of your business of obsolescence and your own business requirement, design changes, public relations as opposed to the deterioration in the building that occurs over a period of time.

The Witness: Yes, Your Honor.

The Court: If properly maintained and still might be a good building—I guess the one you were in from '29 until what?

The Witness: '69.

The Court: —was a good building. Am I correct that those considerations as much or maybe more so as the deterioration in the building that would cause a change in [274] attitude as to your needs?

The Witness: Yes, sir.

By Mr. Williamson:

Q. You have already pointed out it would be the better economic use of $2,145,000.00 for the bank not to put it into a building but to use it in the banking facilities, make money in your normal operations.

At the end of 1965 Worthen would no longer have a building lease. Your building lease runs out at the end of 65? A. After 65 years.

Q. After 65 years. I'm sorry. A. Yes.

Q. After 65 years do you think it would be of great concern to Worthen Bank not to any longer have a lease at 50,000 a year and be placed in a position to have to negotiate for the lease? A. No, because we still own the land. The owner of the building would have to negotiate with us to maintain the building on our land. I think we would be in a strong position.

Q. Do you think Worthen Bank at the end of 65 years would still be in that building? A. I would think not if history repeats itself. I think we probably would have gone through another building besides this one by that time.

[275] Q. Mr. Penick, has it ever concerned you that Frank Lyon Company itself might be sold? A. Yes. It became one of the items of negotiation in the making up of the agreements.

Q. Did you request from Frank Lyon Company assurance that if Frank—that the ownership of Frank Lyon Company changed that Worthen would have an option to buy that property? A. I believe that's in the agreements.

Q. I don't believe you will find it in the actual agreements themselves.

Mr. Williamson: Your Honor, I am going to introduce as Plaintiff's Exhibit No. 50—I would like to offer into evidence as Plaintiff's Exhibit No. 50 a letter from Frank Lyon to Ed Penick dated April 12, 1968.

The Court: Has Mr. Sayre seen this?

Mr. Sayre: I have just seen it. I have no objections to it.

The Court: All right. It is received. Let me read it just a moment.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 50 and was received in evidence.)

By Mr. Williamson:

Q. Would you please state what led to that letter, Mr. [276] Penick? A. I can't recall exactly the circumstances. I know that a number of major appliance companies have started going to their own national distributorships and at that time I think a number of them in our community, such as Philco and General Electric, went direct and I believe my concern was can this happen to RCA distributor, which is the Frank Lyon Company.

Q. Were you concerned primarily with the ownership of the building after the 25 year period? A. No, I'm concerned with the ownership of the building now. Anytime during that period it would change.

Q. Would you state what the price is at which the building would be sold in the event Frank Lyon Company changed hands? A. It was a negotiated price.

Q. And presumably that would be the fair market value at that time, would it not? A. Yes.

Q. And would you expect that to continue after the 25 years when you no longer had an option to buy under the agreements? A. I would think from this letter it would carry through the lifetime of Mr. Lyon's immediate heirs and the current working associates in the Frank Lyon Company.

[277] Q. Who currently own some stock in the company? A. Yes.

Q. I believe that was indicated.

I believe you have already stated in response to the Court, if I heard you correctly, but I will ask you again: Was there any understanding at the time, either written or oral, at the time these documents were entered into that Worthen Bank would ever exercise its option to purchase? A. No. It was never discussed or never a part of any of our negotiations.

Q. At the time these documents were entered into in May of 1968, was there any commitment on behalf of Worthen Bank to make a $500,000.00 loan to Frank Lyon Company equal to its equity investment in the building? A. Not a specific commitment. But the Frank Lyon Company has enjoyed our maximum legal lending limit for many, many years and in that way it would have been available to the Frank Lyon Company as long as they weren't over our legal lending limit that was a million eight. As long as they had not exceeded that they utilized that line as their money demands required.

Q. Was there any discussion at any time that Worthen would loan Frank Lyon Company $500,000.00 to put into this building? A. No.

[278] Q. Did the loan of $500,000.00 in August of 1969 at the time Frank Lyon Company bought the Coca Cola stock, was that loan made—have anything to do with Frank Lyon's $500,000.00 investment in the building? A. Not

to my knowledge and not from the standpoint of Worthen Bank. He had already put the money into the building at the time that came up because the building was 95 percent complete by August of '69.

Q. And you understood that $500,000.00 loan in August of '69 to be for what purpose? A. To purchase a down payment on—to purchase the Coca Cola Company.

Q. Incidentally, referring back to this letter of April 12, 1968, is there any legally binding obligation to sell the building, or is this simply a moral commitment?

The Court: I am not going to need the opinion of Mr. Penick on that.

We are going to have a recess for 15 minutes.

Court will be in recess.

(Recess.)

By Mr. Williamson:

Q. Mr. Penick, you testified earlier in the morning you would never have made reports to the bank regulatory authorities reflecting this transaction as a sale leaseback arrangement if it were a mere sham. During this period, or [279] since this period, have you had to file any report with the Securities and Exchange Commission? A. Yes, sir, we have. In organizing our holding company and the acquisition by the holding company of Worthen Bank and the First National Bank of Hot Springs, we filed registration with the Securities and Exchange Commission. We filed registrations on the acquisition of the National Credit Corporation in Pine Bluff, and this last year we filed with the SEC with the intention of having a public equity offering but withdrew it when the market turned around.

Q. But in all these prospecti, perhaps is the word, has this sale leaseback transaction been reported? A. Yes, sir.

Q. And in your financial statement has the building been carried on Worthen's books as being the owner? A. No,

it's been footnoted by the accountants as a major transaction between the bank and a director, but only in that form.

Q. Hadn't this been a mere disguise of a sham transaction and Worthen Bank being really the true owner of that building, would you or your directors have permitted a prospectus to be filed with the SEC that was misleading? A. No, sir.

Q. Would there be any civil or criminal liabilities exposure to civil and criminal sanction of your board of [280] directors had this been a mere sham? A. I understand it would have been, but it's never been a point of discussion because it was not a sham in any shape or form.

Q. Was Worthen Bank allowed a deduction for the interim interest of some $450,000.00 which Frank Lyon Company paid to First National City Bank on the interim loan? A. No, sir.

Q. Was Worthen Bank allowed any current deduction for any legal or audit expenses in connection with this transaction? A. I don't think a deduction. I think we capitalized—

Q. No, they were paid by Frank Lyon Company? A. No.

Mr. Williamson: No further questions.

The Court: All right, Mr. Sayre.

The Witness: May I volunteer a question? You asked me awhile ago where there was anyplace in these exhibits where I could show the equity proposed by the different proposals and I was not able to find it at that time. It is under Plaintiff's Exhibit 15.

The Court: Yes, I think Mr. Williamson noted that and I find it here. "Lyons (2), $500,000.00; ours, $500,000.00, Lyons (1) $860,000.00; Stephens, $360,000.00."

[281] The Witness: Yes, sir.

CROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Penick, you said that the bank, Worthen Bank, had a verbal commitment from First National City Bank, your correspondent bank in New York, for the interim financing and from New York Life for the permanent financing, subject to finding a suitable investor, an acceptable investor. A. Yes.

Q. So that the bank had arranged for both the interim and permanent financing of the Worthen Bank Building. A. Yes, sir.

Q. And you said that the bank wanted to make absolutely sure that it kept complete control of, I believe you said "our building" or "its building" because you considered it to be, in effect, your building; is that correct? A. Considered it to be the headquarters of our business organization.

Q. But the image of the building was important? A. That's right.

Q. And it was to be dictated exclusively by the Worthen Bank or the directorship of the Worthen Bank? A. The design, layout and construction.

Q. I'd like to draw your attention to Defendant's Exhibits 8, 9 and 10, and ask you to identify those, please. [282] A. Eight is a standard form of contract between owner and architect by the American Institute of Architects.

Q. That was entered into between the bank and the Erhart architectural firm? A. Yes.

Q. This is the architectural firm that prepared the final plans for the building? A. Yes.

Q. That was after the problem over the alley had been straightened out, and the building as it now stands on Capitol was designed by the Erhart firm? A. Yes.

Q. It was designed for the bank? A. Yes.

Q. And Frank Lyon Company had nothing to do with the hiring or design of the building? A. None.

Q. Now with regard to Exhibit 9, would you identify that one? A. This is a letter in the form of a contract from the Carl A. Morse, M-o-r-s-e, Inc. addressed to Worthen Bank and Trust Company to my attention, which is outlining the working relationship for the retention of Mr. Morse as company services—as a consultant in the building of this building.

[283] Q. Again, this contract was entered into in, I believe it is 1967? A. '67. February of '67.

Q. February of '67 would have been some eight to ten months prior to the time that you finally made the decision on the sale and leaseback. Is that correct? A. Before we finally selected the Frank Lyon Company, yes.

Q. Or even the methods: whether it was to be a holding company or a subsidiary or a sale and leaseback? A. Yes.

Q. So the bank had made the commitment to build the building and hired architects and had hired an overseer; is that correct? A. A consultant.

Q. As outlined in that letter there, their responsibilities were to oversee the construction of the building. A. He was to work with the architectural firm in the design of the building and in the receipt of bids from subcontractors and the control of those bids within a prearranged budget.

Q. And he was to act on behalf of the bank? A. Yes.

Q. In dealing with those people? A. Yes.

[284] Q. Now would you identify Exhibit No. 10? I believe that's the front and back page of a rather lengthy instrument. A. It's without a title but it evidently is the contract between Matson Bellows, a joint venture between Maton, Incorporated and W. S. Bellows Construction Company and Worthen Bank and Trust Company for the construction of the building.

Q. And when was that entered into? A. That was entered into November of '67.

Q. When was the ground broken on the building, excavation begun? A. I believe it was September of '67.

Q. So prior to that time there was a contract with a prior contractor or did Bellows do it without a contract? A. They did it without a formal contract.

Q. So the bank itself actually had commited itself to the construction of this building and had hired architects, made plans, and hired a consultant and had actually started construction in September of 1967 at about the time that it was finally decided on whether to use a holding company, a subsidiary, or a sale and leaseback; is that correct? A. We had been working on that all during the year of 1967.

Q. But the final decision with regard to Mr. Wyrick and the regulatory agency came in September, I believe, of [285] 1967.

So about that time, the bank, though, had been—actually began construction of the building itself. A. We had started construction of the building. We knew we were not going to be able to finance it on the balance sheet. We were going to go off balance sheet with it early in 1967. We knew we could not finance it ourselves.

Q. Now with regard to the amount Worthen Bank was carrying on its balance sheet at that time, I believe you had capital of about $4 million? A. Correct.

Q. And you had capital and unrestricted surplus slightly in excess of that amount, four point four million, something like that? A. Right.

Q. The land cost about a million four hundred thousand? A. Right.

Q. And the construction of the garage was estimated at a million two hundred thousand? A. Yes.

Q. So approximately two point six million totally to be invested by the bank? A. Yes.

Q. Now it was also contemplated that the bank would have other expenditures to put into the building; is that correct? [286] A. Yes, sir.

Q. And that was to run up to the maximum that would be allowable under the capital structure? A. $4 million.

Q. So that the bank when it went into this was going to put in another approximately $1.4 million into the building; is that correct? A. One point four million into the building?

Q. You had two point six million in the parking lot and the land and you were going to try to carry as much as you could on your books. A. I think it is pretty well outlined in some of these exhibits, if I can refer to the particular figures.

Q. Certainly. A. In September of '67 in a letter to Mr. Adams in which we sent projections that we would have a total of $4,353,000.00 in land, building and leasehold improvements, we would sell the existing building or carry that figure of $600,000.00 which would bring us down to a total of three million seven hundred fifty-three thousand on our books.

Q. So three million seven. And the bank anticipated putting a million one, two or three hundred thousand into the new building? A. Yes.

Q. And I believe yesterday Mr. Cotham's testimony that [287] this was to be specialized banking equipment such as the vault, this type of thing? A. Leasehold improvements.

Q. He also said the leasehold improvements included things like paneling and built-ins and paint. Was there a cost overrun on the building in excess of the amount estimated? A. No.

Q. So it came in on budget then, and part of the ownership of the leasehold improvements are in things such as paneling on the walls and this type of thing? A. Really I think some is in improvement. I don't know specifically about paneling on the walls. Certainly I wouldn't think paint as being in leasehold improvements. That's a standard building product.

Q. Do you know what makes up the total amount one or two million dollars? Is this identified? A. It is identified on the books of the bank. I could get you that. I don't personally know exactly how it's broken down.

Q. At any rate, the total amount that Frank Lyon Company or the price agreed to in the sales agreement was seven million six hundred forty thousand and that was a firm price. The bank would finance on its books any amount in excess of that amount? A. Up to the maximum permitted by the regulatory [288] authorities.

Q. As you earlier stated, the bank wanted to finance as much as it could up to the four million because it was cheaper for the bank to finance it on the books. A. Yes.

Q. The cost of money was about five or five and a half percent to the bank? A. Yes.

Q. Also I believe that once the bank had made the decision to go with the sale and leaseback you wanted an investor that would not interfere with the bank's plans; is that correct? A. Yes.

Q. In other words, you wanted somebody—as far as the construction of the bank and the types of materials or who the contractor was—was to be passive. They were to make only an investment; is that correct? A. That's right.

Q. All during this period of time would you explain to the Court what steps were taken or how physically the construction of the building took place? In other words, who oversaw the construction of the building besides Carl Morse Company? A. We had an employee called clerk of the works that was on the building site. Of course, the architectural firm [289] oversaw it. We had a man on our staff that was the building projects manager from the bank's standpoint that was housed in the main bank and had the main responsibility of leasing the building.

Q. The clerk of the works then was an employee of the bank who would be on the job site? A. That's right.

Q. Did Frank Lyon Company have anybody on the job site? A. No. Not to my knowledge.

Q. Excuse me. I served a subpoena upon you asking you to bring various documents, many of which you and Mr. Williamson, through courtesy, have gone through and

pulled out the Defendant's Exhibits 8 through, I believe, 17.

Also there is—I requested you to bring daily work reports of contractors or architects. Those have been produced. I don't see them right now.

The Court: Mr. Sayre, what is the purpose of this? If I'm not mistaken, the purpose is to make clear that the investor, the plaintiff here, had nothing whatever to do with the control of the construction, the design of the building, the supervising of the construction.

Mr. Sayre: That is correct.

The Court: It is conceded, admitted and not at issue. We can keep proving it.

Mr. Sayre: I will try to terminate it then.

[290] The Court: It is unnecessary.

By Mr. Sayre:

Q. Then, Mr. Penick, with regard to those reports, there was a report for each day submitted by the contractor to the bank; is that correct? A. They didn't come to my knowledge. I don't know they were submitted but it didn't come to my office. I'm not familiar with them.

Q. Would you please refer to Plaintiff's Exhibit No. 13? The fourth paragraph, which is one line long, says that all investment tax credit and tax savings will accrue to Worthen Bank.

It was the desire of Worthen to save approximately a hundred twenty-five thousand in sales tax? A. Yes.

Q. By buying the materials, putting them into the building and then, as the contract reads, I believe, sell the building to Frank Lyon Company brick by brick, or as the material was put in? A. Yes.

Q. And the investment credit, the federal income tax credit, was passed on to Worthen Bank then? A. Yes.

Q. This is on the material placed in the building? A. Yes.

[291] Q. Now with regard to the specific items, paragraph one says "equity to be supplied by investor $500,000.00, and annual rate of interest to be charged thereon, six percent."

Why did the bank use the term "rate of interest" which indicates a debt or a loan with interest to be charged on it? Why did it choose those terms? A. Well, I think you could put rate of return. I think we deal in interest, and the person writing this up—it's just a clear expression that that's the rate we would pay on the equity.

Q. And I believe you stated the amount was calculated by taking what the option prices would be and making—if the options were exercised, that the amount to be realized would be six percent on this $500,000.00? A. No, I think—I think it was the other way around. That the rate of return we would pay determined the option price.

Q. What I'm trying to get at, the option prices were determined to give the investor a six percent return on the $500,000.00 if and when an option would be exercised? A. That's right.

Q. Do you know why there was a change between the rent—not the rental payment—yes, rental payment here, after 11 years? A. Yes.

[292] Q. Why is that? A. Well, I think that's explained in the second paragraph. Instead of having 11 payments for the rent, we wanted to pay the rent—we wanted the first ten or eleven years the opportunity to get rented up and get comfortable in the building. We didn't want to make straight 25 year level payments. If we paid the first 11 years 90 percent of those payments that would have been necessary to retire that percentage of it and made it up in the next 14 years, and that's explained in the second paragraph of Exhibit 13.

Q. With regard to the actual leasing of the building I believe you stated at one time or the other—

The Court: Let me read that paragraph.

All right. Go right ahead.

By Mr. Sayre:

Q. The leasing of the Worthen Bank Building has been highly successful by the bank; is that correct? A. Yes, it has.

Q. And the bank's rental is equal to the debt service required on the permanent financing, correct? A. The amount that we received.

Q. Your rental under the net lease? A. The rent that we pay to the Frank Lyon Company, yes.

Q. And then you have the right to sublease space within your building; is that correct? [293] A. Yes.

Q. And that has been a profitable venture for the bank? A. Well, it depends how you calculate it accounting-wise. We have been able to live in the building at less than we originally projected it. When we charge ourselves our cost of occupancy, we still pay substantial amount to use the building ourselves.

Q. How much does the bank occupy, how many floors? A. We occupy a hundred ten thousand square feet of a total of about three hundred fifty. Floorwise, we occupy the most part of ten floors. However, we don't occupy all of them exclusively. And we charge ourselves with—there's one floor, a public floor, the fourth floor, doesn't have anything but meeting rooms and conference rooms on it and we charge ourself with it.

Q. On the second page—

The Court: Let me interrupt just a moment. Back there in August or September, getting ready to build—in fact, I think you started in September—how much of the building had been leased?

The Witness: When we started just the part that we wanted had been actually leased. We had some letters of intent.

The Court: How many letters of intent? Of course, this was looking—when did you open for occupancy?

[294] The Witness: December of '69.

The Court: How many letters of intent did you have in terms of other tenants who might sublease?

The Witness: By number, I think it would be very few. By square footage, we had some pretty substantial indications of interest because, as I mentioned, the Tower Building tenants were coming up on ten year anniversary of their leases. We were working very hard on some of their tenants and we had indications of interest.

The Court: Would you say you had indications of interest as to any occupancy of any square footage in the building?

The Witness: Yes, I would estimate of the total square footage in the building including the space Worthen would occupy—and at that time we had projected moving our computer operation into the building—that we had about 60 percent projected occupancy.

The Court: By the time you started building?

The Witness: By the time we started building, yes, sir.

The Court: You may continue, Mr. Sayre.

Mr. Williamson: Your Honor, I didn't quite hear the last remark.

The Witness: Sixty percent.

Mr. Williamson: By the time you started building?

[295] The Witness: Including Worthen's space we projected using. We had originally projected moving our com-

puter operation and our proof and transit, which would have taken two floors. As it turned out, we did not move them into the building but at the time of September of '67 we were going to move them into the building.

By Mr. Sayre:

Q. Following that up, how did the rentals go after construction actually began or commitment? A. They went very well.

Q. And by the time the building actually opened, was it virtually rented? A. By the time it opened there were leases signed or letters of intent for over 90 percent of the space in the building.

Q. Now on page two of Exhibit No. 13, there is a paragraph five, which has the options of Worthen Bank to repurchase subject to assumption of the mortgage by Worthen. What are those figures in parentheses out there? The discount amounts or discount factors? A. I can't figure exactly what those are unless it is the difference between six and six and three-quarter percent. And I didn't calculate them.

Q. That would be then the return on equity investment by a potential investor? [296] A. That's right.

Q. And savings to the bank would be that discount factor? A. Yes.

Q. The difference between the payment to the—excuse me. The interest on the long term financing? A. Yes.

Q. Now with regard to that, you stated earlier in response to a question of Mr. Williamson that the bank would probably not exercise the option because of a difference in interest rates. Doesn't the Worthen Bank have the right to assume the mortgage, if it chooses to exercise the option to purchase, to assume the mortgage at the interest rate stated? A. Yes, but we would have to come up out of our own capital with the difference to pay this off.

Q. Or you would have to have an infusion of capital through another issuance of capital debentures or equity?

A. When we assume that mortgage we would have to show it as a liability on the statement.

Q. But you said you would have to—I think you said you would have to change your interest rate from six and three-quarters to ten and a half. My question is: If you had an equity offering you mentioned and infusing capital by way of equity, you could assume that mortgage at six and three-quarters? [297] A. Yes.

Q. From New York Life? A. Yes. But only in Worthen. We could not if we went off the balance sheet. I don't believe the right to assume is assignable.

The Court: Let me ask in connection with, say, any options prior to the paying off of the loan. Is there a specific provision on these instruments contemplating that possibility in terms of New York Life? Did they contemplate or take into consideration in their documents the possibility of the bank exercising these options at some time prior to the termination of the loan?

The Witness: There are penalty provisions for prepayment.

The Court: Well, there are prepayment penalties. Let's say the bank exercised its option at the 15th year. Is there any provision in there that the plaintiff would be released by New York Life from its obligation under the note and mortgage upon the bank's exercising the option and assuming? It is clear it has the right to assume the balance. But the question is is there a further provision that in that event the plaintiff is released from its obligation?

Mr. Sayre: I do not recall, Your Honor.

Mr. Giroir: I don't recall, Your Honor, but I will look it up and see.

[298] The Court: Absent such a provision, the plaintiff would continue liable, unless someone corrects me, upon the note, and if the bank defaulted the plaintiff would still be obligated. Is that not correct? Absent some release?

Mr. Williamson: That would be true as a general principle of law.

The Court: Unless there is an agreement to the contrary. All right, I wanted to get that clear.

By Mr. Sayre:

Q. In arranging the financing with City Bank and also with New York Life—and this was done, I believe, in the summer of 1967—you had a commitment from them—— A. Yes.

Q. —prior to the start of the building?

That as part of that commitment the bank agreed to pledge or mortgage or subordinate its interest in the land and the parking garage as additional security for both the interim financing and the permanent financing; is that correct? A. That's correct.

Q. Why would the bank agree to pledge its unencumbered assets for the loan of, I suppose, unrelated third party? A. I think for two reasons. The first primary reason is the interest rate. The better quality of loan we could make the better interest rate we could anticipate getting from both the interim and the permanent lender.

[299] Second, it was a single unit. The parking deck was not workable without the building; the building was not workable without the parking deck. We were behind it from the standpoint it was going to be our office building and we had the assets there and we could help ourselves. We were going to pay the interest in the long run. It made sense to us to provide that additional equity.

The Court: Let me ask you this: As of September or prior to the time Frank Lyon came into the picture, were those arrangements already negotiated? Was it understood with interim and permanent financing that you would subordinate this investment to the mortgage of each as additional security to them?

The Witness: Yes. Yes, sir.

The Court: And indirectly then you get the benefit through better terms and I think you are also saying it is an economic unit. No mortgage would take one without the other because it wouldn't operate, in effect.

The Witness: Yes, sir.

The Court: Those determinations were made before the plaintiff entered this picture and would have obtained, I gather, whether the plaintiff was successful or anybody else——

The Witness: Yes, sir.

The Court: —was successful as the investor?

The Witness: It didn't make any difference who was [300] the investor. We were looking at the overall ultimate cost to us. We were going to have to pay the interest rate regardless of who owned the building. If we could negotiate one half of one percent or three-fourths of one percent better by using the additional security of the land, we thought it was to our best interest to do so.

By Mr. Sayre:

Q. With regard to that, Mr. Penick, you are saying then that the bank's purpose for finding an investor was to satisfy the Federal Reserve requirement of getting the title to the building or determined ownership of the building off the balance sheet; is that correct? But that in a practical effect, the costs of the building were going to be passed through to the Worthen Bank to pay the financing off; is that correct? A. Yes.

Q. And this was understood and calculated prior to the time even that Frank Lyon got into the picture? A. Yes.

Q. It was the bank's arrangement with New York Life and with First National City Bank? A. Yes, that's right.

Q. Now with regard to the ground lease, the $50.00 figure was set, again, by the bank so that there would be no increase in rent on the property? A. To ourself.

[301] It was considered as a wash by the bank? A. Yes.

Q. So that the bank was putting up this building and receiving financing—had commitments for financing and was going to pay it, as I think you said, indirectly so it was a cheaper method for the bank to continue to own the ground under the two structures: the parking garage. A. One of the primary objectives was to get into the building at the least cost to us. One way we could do that was not to run the cost up on ourselves: whoever the investor may be, by not charging him a ground rent which he would have to roll into the rent he, in turn, would charge us. I was a washout.

Q. I believe you originally said that the plan was to get a holding company formed as a subsidiary to issue additional debentures. These are considered capital as far as the federal regulatory agencies go. A. Yes.

Q. To issue that amount, turn that money over in return for stock of the subsidiary and then have the subsidiary borrow money on the outside. But the reason that this wasn't done was because of the state requirement of payment of six percent interest would not have floated or caused the bonds to have been sold in the market at that time? A. There were two reasons. That was a reason we were not familiar with that provisions of the Arkansas law at that time. The second reason was that Mr. Wyrick told us any [302] investment in a wholly-owned subsidiary would be changed the same as the investment in real estate, so we accomplished nothing.

Q. But it was the bank's intention originally, the plan that had been chosen and you started to go through with it by asking for approval, would be to acquire or cause another $4 million in capital to be created on the bank's books? A. We were exploring any way of financing—the best way of financing this building. We had not zeroed in on any one plan until we developed sale and leaseback as the best method for us.

Q. Some decision had been made when you went to the regulatory agencies to request their permission. A. Yes.

Q. And I believe in the correspondence you said you scrapped that plan because you couldn't float the bonds; is that correct? A. Yes.

Q. Or the debentures? A. Right.

Q. So at that time the bank did not have any qualms about creating another $4 million in capital that would be tied down or held because it was the cheapest way for the bank to go to build the building; is that correct? A. That's correct.

[303] Q. The options that appear on Exhibit 19, which is the building lease and also on Exhibit 13—they are referred to on 13 and I believe the final options appear on 19, probably paragraph 20.

The Court: Do you know the page?

Mr. Sayre: Twenty-five.

The Court: All right.

Mr. Sayre: Could I ask the clerk to borrow the stapler?

By Mr. Sayre:

Q. Could you tell the Court, please, how these dates were determined and how the purchase price was determined? A. I am not familiar with exactly how those were determined.

Q. Didn't you testify earlier that the purchase price was determined on the basis of the outstanding debt or the unpaid principal of the mortgage plus a six percent factor on the five hundred thousand was the way we got the purchase price? A. No. I said the amount we would pay the investor was determined by the interest rate factor plus the amount of his equity. I don't believe I said the unpaid balance on the note. Evidently, that is the way that was determined.

Q. How were the dates determined: the 11th, 15th, 20th and 25th year? And why were they chosen? A. I don't remember.

[304] Q. You were on the finance committee that worked on this, weren't you? A. Yes.

Q. Do you remember any discussions about it or discussions with Mr. Gates about it? A. No. Well, the 15th year sticks in my mind because that's when the bank commissioner insisted that we have in our right to purchase, and the other I don't know why they were just chosen on five year intervals.

Q. Do you recall any discussion—and you said you looked at the tax consequences of this—any discussion that Internal Revenue code provided a penalty for recapture of excessive depreciation if a building was held for less than ten years, but no recapture subsequent to that time and that this would be a factor that would make it attractive to an investor? A. I'm not familiar with whether that went into those provisions or not, but I do know that, of course, we wanted to take advantage of the provisions of the tax law where it was at our best interest to do so.

Q. Now with regard to Defendant's Exhibit No. 18, which is the record Frank Lyon's journal entry of the loan, the Coca Cola loan was made in 1969 for about $500,000.00 and for one year. Now with regard to the testimony, it's been to the effect that the bank and Frank Lyon worked out a deal where the [305] bank would recover its hundred and five thousand dollars and promised rent reduction on the first five years of the lease through increased interest charges paid by Frank Lyon. Is that in essence the deal that was worked out? A. I think the arrangement was to pay us increased interest in order to meet the obligation of the reduced rent which they were unable to do, due to the fact New York Life did not permit the contract to be drawn with that provision in it.

Q. And that agreement was reached between both representatives of the bank and Frank Lyon Company. It

was understood that the excess rental over the prime rate or their usual lending rate would be applied to reduce an obligation of a hundred five thousand dollars connected with the reduced rentals? A. Yes.

Q. And I believe your testimony has been that to date only about one-fifth of that about has been discharged. A. Yes.

Q. And why hasn't the rest of it been discharged? A. The interest rates in Arkansas couldn't go over ten percent. There wasn't any way. The prime rate went to 12 percent. There's been no way to pay rates in excess of ten percent so we will have to work out another arrangement.

The Court: Although it's been somewhat—since '69 [306] that differential only existed there for a short period of time and upon the renewals, in effect, they are not paying you anything more than they would have to pay otherwise.

The Witness: That's right.

The Court: Under Arkansas law they can't pay above ten anyway. Is that the answer?

The Witness: Yes, sir, that's the answer. It is easy calculated as to the total amount still owed. I have not calculated but the total amount owed under an obligation of a hundred five thousand dollars can easily be computed. It's a recognized obligation from the Frank Lyon Company to the Worthen Bank and it will be paid, I'm sure.

By Mr. Sayre:

Q. And the interest was raised to ten percent on this note, I take it, and the maximum has been charged? A. I feel sure that it was, but it is a year's note.

Q. That's what I am asking: When it was renewed would the interest rate be adjusted? A. It would have gone up to that figure.

Q. Then why has the bank continued to renew this on a yearly basis, and if the interest rates are going to remain does the bank plan to continue to renew this note? A. Well, circumstances being the same, the quality of the credit continuing good—that's the purpose of handling it on a year-to-year basis—that it would be our intention to [307] renew it as long as the Frank Lyon Company enjoys the esteem of our organization.

Q. So you are saying originally there was no agreement to make a loan of $500,000.00 to Frank Lyon Company at the time they made an investment in the building of $500,000.00. A. Never mentioned or discussed.

Q. But that the interest on this $500,000.00 loan for the Coca Cola stock was tied into the repayment of a reduced rental on the building financing; is that correct? A. Well, the interest was in payment of an obligation of a hundred five thousand dollars, which had originally been the commitment to reduce the rent by $21,000.00 a year. When that became unacceptable to New York Life Insurance Company, it did not detract from the fact that $105,000.00 obligation still existed between the Frank Lyon Company and the Worthen Bank.

Q. Excuse me. My question was that obligation was tied into the interest on this loan and was to be reduced through that method? A. The $21,000.00 obligation arose out of the original agreement in the sale and leaseback.

Q. But the repayment or the payment of that $105,000.00 obligation was tied into the interest factor on this loan? A. Yes. But not at the original inception. I thought your question was the original inception at the time. It was [308] not.

Q. This was at the time this loan was created. A. Yes.

Q. This Coca Cola loan was created. A. Yes.

Q. And your statement is that as long as Frank Lyon Company wants to hold that out and pay the going rate of interest the bank will continue to renew these one year

notes; is that correct? A. As long as the quality of the credit remains the same.

Q. I believe you said there was a credit line of some $2 million. A. Yes.

The Court: Let me see if I understand. The plaintiff has enjoyed a good relationship with your bank for a long time.

The Witness: Yes, sir.

The Court: And do I understand that from let's say September of 1967 or prior to that on up to now that it's had a line of credit with your bank?

The Witness: Yes, sir.

The Court: And that line of credit has been and is $2 million?

The Witness: It's been our maximum legal limit as [309] a state bank. It was 20 percent of our capital and surplus which was a million eight, and now as a national bank it is two million eight. We have added additional capital to it. They enjoy our maximum legal limit.

The Court: And that depends on your own balance sheet, so to speak——

The Witness: Yes, sir.

The Court: —as to what their maximum credit line is with you?

The Witness: Yes, sir.

The Court: Was it changed at any time as a direct result of their agreement to act as an investor or was their credit line completely independent of this agreement or simply followed your own balance sheet in terms of your most favored customer?

The Witness: They have enjoyed our maximum legal limit to my knowledge for 20 years and its's always been in

excess of the $500,000.00 that is in question, and in no way did the credit relationship of the Frank Lyon Company tie into their financing of our building.

The Court: That will be clear because people use the term loosely "a line of credit". All that means is you cannot lend to this particular customer more than that amount by virtue of law. It does not constitute in any way any commitment to make any particular loan, does it?

[310] The Witness: No. By matter of law it means when we issue a line of credit to a company that we will hold that amount of credit available for them, but it is considered to be normal commercial credit. That's normally that they would come in, borrow it for a short term period for inventory and accounts receivable and repay it.

The Court: When you take up a loan to buy stock——

The Witness: It's different negotiations generally, and if the loan is to be of a term nature that's normally outside of the regular line of credit.

The Court: All right.

By Mr. Sayre:

Q. And it was understood at the time this loan was entered into that even though it was a one year loan that it would be on a long term basis? A. We understood there probably would be no repayments until after the stockholders of the Coca Cola Company had been paid and that payment, I believe, was over a four or five year period.

Q. And no payment has been made to date; is that correct? A. Not to my knowledge.

Q. And some five and a quarter years has expired since that time? A. Yes.

[311] Q. Now the the Worthen Bank shortly—in the time between 1967, '68, '69 when the building was planned and constructed and the present time, the bank has changed its

charter from a state bank to a national bank; is that correct? A. Yes.

Q. And it is under the control now of the Office of the Comptroller of the Currency? A. Yes.

Q. What are the restrictions on the bank on building requirements again and ownership with regard to the Comptroller of the Currency? Are they the same as the Federal Reserve? A. They are not as specific. I believe forty percent of your capital in surplus is about the maximum that the Comptroller will permit, and he has a good bit more flexibility in the rules and regulations than the Comptroller does.

Q. You mean than the Federal Reserve does? A. Excuse me. Than the Federal Reserve does.

Q. The Comptroller of the Currency would allow forty percent of the capital and unrestricted surplus or any surplus? A. I think it's any surplus.

Q. What was the surplus of the Worthen Bank. You said the capital was—— A. It's five million also. However, the important point to us is we are not from under the Federal Reserve because under the Bank Holding Company Act of 1970, the Federal Reserve [312] still dictates to us our capital ratios. It was the Federal Reserve that required us to put in the $5 million. We were a national bank in 1972 when we put in the $5 million additional capital.

It was a Federal Reserve through the workings of the Bank Holding Company Act that required that additional capital and not the Comptroller.

Q. When you say "the workings of the Bank Holding Company," does it refer to any bank or because you have state banks within your holding company? A. No, Bank Holding Company Act refers to any company that owns a bank.

Q. So as long as the FABCO entity is in existence Worthen and FABCO will be under the control of both the Comptroller of the Currency and the Federal Reserve. A. That's right.

Q. Now with regard to the testimony you said with the SEC you had an equity offering that was going to be brought on the market or intended to be? A. Yes.

Q. How much capital was to be raised through that equity offer? A. We were trying to net $6 million.

Q. And what was the purpose of that? A. It was to supply the capital to the holding company [313] that would be needed.

Q. To FABCO? A. To FABCO. It would be capital acquired on the holding company level and be needed to fund the capital requirements of the subsidiaries.

Q. So in other words it would be passed through—the capital would be passed through to each bank that was a subsidiary as needed?. A. Yes.

Q. You said there was an infusion of $5 million in the last two years? A. Yes.

Q. So you now have $10 million in capital? A. Yes.

Q. Did part of this infusion of capital, was it required because of the acquisition of the old Blass building and conversion into a center? A. No. It had no part of that.

Q. Has the bank purchased and carried on its books the old Blass building? A. Yes.

Q. What is the anticipated cost on remodeling? A. The cost of the building was about nine hundred sixty-five thousand. We will receive—there is a lease outstanding on it from Dillard Department Stores, and over [314] the term of that lease I think we will receive about $450,000.00 and the building will net costing us a little over four hundred fifty or five hundred thousand dollars. The remodeling is going to cost about a million and a half.

Q. So the investment on the books will be between two and two and a half million dollars; is that correct? A. Yes.

Q. And that was covered by the infusion of new capital? A. Well, that is the only reason we could go up that high is because we had put in the additional capital. It was not necessitated by the acquisition of the Blass building—came

after we put the capital in. The capital was required by the Federal Reserve in our application to, I believe—to acquire a mortgage Company, L. E. Lay. That not only required us to put in additional capital of Worthen but the First National Bank of Hot Springs was required to raise additional capital which they did.

Q. Where did the capital come from? A. FABCO borrowed the $5 million on a term loan from the Chemical Bank of New York. That was the purpose of the equity offering was to repay that term loan to Chemical Bank.

Q. Would you refer, please, sir, to Defendant's Exhibits 14 and 15? Also, No. 13, which is a letter by Mr. Gates, I believe, to the law firm of Rose, Meek, House, Barron, Nash and Williamson at that time.

[315] In Exhibit No. 13, Mr. Gates is asking for legal advice with regard to the creation of a subsidiary corporation to own the proposed bank building and a leaseback and what the effects would be, and the response is in Defendant's Exhibit No. 14.

The Court: What are the dates of those? What is 13?

Mr. Sayre: Thirteen is September 21, 1966 and fourteen is October 13, 1966.

The Court: All right.

By Mr. Sayre:

Q. One of the questions that was addressed in this letter was "What would be the tax result or the tax consequences —" This is Defendant's Exhibit 14. "—of the proposed creation of a subsidiary to hold the property and then a rental from that subsidiary?" The response of Mr. Meek was to the effect that it would probably be disregarded by the Internal Revenue Service. Is that basically—— A. I can't recall from memory what Mr. Meek recommended.

Q. This is on page two under the heading Roman numeral one "Income Tax Consequences": "The Treasury Depart-

ment would take the position so far as the tax consequences are concerned that the bank is obtaining a loan on the building and would disregard the fact that the title is vested in the subsidiary and that the loan is being obtained by the subsidiary. The [316] Treasury Department would treat the lease contract held by the lendor or assignee of the subsidiary as being in reality a security agreement. Therefore, the Treasury Department would do the following with respect to the liability:"

He sets forth the bank could not deduct the rentals for tax purposes; the bank could, however, claim a deduction for the portion of the rental payment allowable on interest and also, No. 3, the depreciation; and that no capital gain or loss could be realized on the transfer.

He then cited several authorities which were attached to that letter, one a law review article dealing with—I think out of the banker's magazine—dealing with sales and leasebacks and also a copy of a letter ruling from the Internal Revenue Service to another bank.

In 1966, then, the bank was aware that there existed a possibility or a probability of a disregarding of the sale and leaseback arrangements if a subsidiary corporation was used as the owner or holder of the building; is that correct? A. Well, I think the first paragraph pretty much distinguishes the difference when the first premise was that the bank would create a wholly-owned subsidiary having a rather nominal capitalization. The steps we proposed to take, it would not have a nominal capitalization. I think this letter was an effort on the part of Mr. Gates in exploring all possibilities to find out what areas we should look further in and what areas would be precluded to us.

[317]Q. And that was as early as September of 1966? A. Yes.

Q. If you will refer to Defendant's Exhibit No. 15, which is a letter from the same law firm but Mr. Giroir this

time dated September 8, 1967, and it's to the Worthen Bank——

The Court: What is the date again. I missed that.

By Mr. Sayre:

Q. September 8, 1967. This in line with the plaintiff's Exhibits, correspondence between you as the president of the bank and the regulatory agencies was at the same period of time you were discussing matters back and forth with the Federal Reserve and State Banking Commissioner; is that correct? A. Yes, that's correct.

Q. And the bank then had requested a legal opinion with regard to the ultimate financing that was planned or that was actually used; is that correct? A. That's correct.

Q. And the legal opinion rendered states that they believe the law firm gives you the opinion in their opinion that it would be a viable transaction.

And then on page number six there is—and seven—there is a description of what the position of the bank would be should the Internal Revenue Service disregard the transaction and treat it simply as being—the bank being the owner of the building. It sets forth that the depreciation and the [318] interest would be allowed.

Now since—excuse me. The bank did receive this opinion; is that correct? A. I assume they did. I'm not personally acquainted with——

Q. It came from the bank's file you produced pursuant to the subpoena so it is contained in the bank's records? A. Yes.

Q. Since the questioning of this arrangement by the Internal Revenue Service, the rental deduction claimed by the bank has been disallowed; is that correct? A. Yes, sir.

Q. And in its stead the bank has been allowed a deduction for depreciation and the interest paid on the financing

to New York Life; is that correct? A. I'm not personally familiar with what adjustments have been made on the statement, on the tax statement.

Q. You said you don't know whether or not that depreciation has been allowed? A. I do not know.

The Court: Are you saying, Mr. Sayre, that since the controversy arose the bank has been deducting—depreciating the building on the tax returns and deducting interest?

Mr. Sayre: No, Your Honor. I believe the bank has continued to treat the transaction as it was treated originally, [319] but what I was trying to establish is the position taken by the Internal Revenue Service has been to allow the bank the depreciation and the interest deductions. not I don't believe in the same amount claimed by Frank Lyon because of the election for double declining balance but the depreciation deductions attributable to the building have been allowed to the bank by the Internal Revenue Service, that an inconsistent position has not been taken by the government.

Mr. Sayre: Refer to Exhibit 16 and 17, please.

The Court: Is this Defendant's Exhibit?

Mr. Sayre: Defendant's Exhibit No. 16 and 17. Defendant's Exhibit No. 16 for identification purposes is a compilation of schedules and memoranda entitled "Financing Methods" and has "confidential" stamped across the front of it, and consists of about ten or twelve pages.

Defendants Exhibit No. 17 is, again, a compilation of schedules and is called "Comparison Owning Building with Sale and Leaseback". I think we can stipulate these came from the records subpoenaed from Mr. Penick.

Is that correct, Mr. Williamson?

Mr. Williamson: Yes.

Mr. Sayre:: From the bank's records.

Mr. Williamson: Your Honor, the bank produced all these records having to do with any phase of this transaction. These did come from the bank's records. I do not know, however, [320] the date of this comparison of owning and the sale and leaseback. I don't know when the comparison was made. It's undated.

By Mr. Sayre:

Q. With regard to Defendant's Exhibit No. 16, there are numerous methods—four, I believe—outlined as to how to finance the structure. This would then have been sometime in the early planning stages that this memorandum was drawn? A. Yes.

Q. And there is following that a series of schedules showing various computations of projections by the bank. There is also in there a proposal entitled "Stephens" which I believe is on about the sixth or seventh page in.

Was that with regard to the Stephens and Eastman Dillon offer? A. Stephens, I'm sure, refers to Stephens, Incorporated, investment banking firm. I cannot say whether that included the Eastman Dillon offer or not.

Q. Following that page there are a series of three pages, I believe, a report to you from Mr. Richard F. Gates. This was the vice president in charge of the finance committee? A. Yes.

Q. And they are dated August 11, 1967, reporting on a trip to New York for financing the new bank structure. They described the negotiations with several investment banking firms, New York Life Insurance Company, and serveral banks. This would [321] have been, again, approximately a month before actual groundbreaking occurred. At the back of those there is a comparison or schedule entitled "Comparison of Financing Methods, Sale and Leaseback, $7.5 million, 25 years." There is a comparison between Stephens, which I take it to be Stephens, Inc.; is that correct? A. Yes.

Q. And that was the Stephens, Inc. and Eastman Dillon by that time? A. I can't say whether Eastman Dillon was in on that one at that time or not.

Q. One of the plaintiff's exhibits is the Eastman Dillon proposal No. 39. A. Well, Eastman Dillon made its own proposal and Stephens made their own, and then they got together. This is undated and I don't know the date of when they got together, so I couldn't say whether they were together at August 11 or not.

Q. Throughout this period you had a firm commitment from Stephens and it says Goldman Sachs was tentative? A. Yes.

Q. I believe—then did Goldman Sachs later or at a subsequent time firm up that offer or make a firm offer? A. Yes, they did.

Q. Now the last page is not very clear but it is a copy on what is originally lined yellow paper with the Worthen [322] stamp on it. It's entitled "$7.5 Million Office Building Investor's Income Assuming Life of Building is 40 Years, Depreciation on Double Declining Balance Basis through—" and it's got 14 year straight line 16th through 25th year.

There follows a series of computations: 25 lines for lease payment income, depreciation, interest paid on mortgage plus interest on balance, net income or loss and accumulated net income or loss.

Was this prepared by the bank as a computation to determine what the maximum tax benefit would be under the double declining balance method of depreciation? A. I can't say from my knowledge why this memorandum was prepared or by whom it was prepared, but I think it was prepared probably to assist us in knowing what we were negotiating against, what was the value to a proposed investor of an investment of this nature and to assist us in our negotiations. But I can't say who did it. I don't recognize the handwriting.

Q. With regard to line number 11, which would indicate the 11th year, there is a maximum benefit under accumulated loss of $1,620,123.30. I believe the last page of Defendant's Exhibit No. 17 is also that same page except there's been a pencil mark on No. 15—or that the 16th year has been scratched out and the 15th put in there and there's been a dot placed alongside the line of number 11 of the maximum loss [323] accumulated.

Was it part of the finance committee's recommendation that an investor be advised that they could enjoy the maximum tax loss or tax shelter by buying your building and depreciating it at a double declining balance method? A. No. We were dealing with sophisticated investors that knew more about this business than we did. One of the reasons that we explored every possibility was that we were in the learning process.

People like Eastman Dillon and Stephen and Goldman Sachs were doing this almost on a daily basis and it was a one-time round for us.

Q. This sheet was prepared on bank's stationary and comes from the bank's records. It was, I think you said, probably prepared to acquaint the finance committee then with what position— A. What position the person on the other side of the table: what were his strengths, how was he dealing. I'm sure he was looking at a schedule such as this.

Q. Now with regard to the proposal that you made in the specifications, Plaintiff's Exhibit No. 13, there is a computation of the repurchase or options exercised at the end of 15 years, and your testimony was that it was calculated, as you recall, because of the Banking Commissioners statement.

On Exhibit No. 14, the next exhibit which is [324] acceptance by Frank Lyon Company of your proposal, in paragraph six of the second page there is a repurchase sum-

mary at the end of the 11th year. Do you recall a discussion or questioning of why that provision was put in the acceptance letter? A. No. I think that the acceptace letter looked like it just recopied what we had put in our specifications.

Q. Basically, it does except for paragraph six refers to repurchase at the 11th year where your letter had repurchased at the 15th year. What I'm asking you is do you recall any conversations with Mr. Lyon or representative of the company as to why the 11th year was inserted on their acceptance of your counterproposal? A. No, I don't recall any reasons for that.

Q. You don't recall any conversation about it? A. No.

Q. And again, it was your testimony that you believe that the "C" part of that subparagraph six "add any premium or deduct any discount" was, again, the difference between the interest factor of six and six and three-quarters percent? A. I believe that's what it was. I didn't calculate it but I think that's what it is.

Q. If you will refer, please, to Plaintiff's Exhibits 45 and 46, I believe—at least 45. This is a schedule "Comparison of Annual Rents with Total Depreciation and Interest for Ten years". It was figured on a straight line basis. May [325] I ask: Did you prepare this exhibit? A. No, sir.

Q. Do you know who did prepare it? A. No, I don't.

Q. So the bank did not prepare or have this exhibit or a similar exhibit when it was entering into the financing of bank structure? A. Not to my knowledge.

Mr. Williamson: Your Honor, this was prepared at my request by Mr. Louis Shuffle, Comptroller of the bank, two or three days ago for use as an exhibit in this case.

The Court: Very well. Let me just interrupt you a moment. It is ten after 12:00. And I don't mind working to see that you make your airplane but on the other hand—

Mr. Sayre: I realize that, Your Honor. I think Mr. Penick is the last witness of any length. I don't want to say in stature, but of any length we are going to have and I would like to—I think I could finish here in another ten minutes at the most probably with my cross examination.

The Court: Very well. On that assumption, we will proceed.

Mr. Giroir: Just a point of clarification. The question you raised a moment ago as to whether Frank Lyon is relieved of liability on the note in the event they exercise the option. I reviewed the option and I don't find any [326] provision for the release.

The Court: I am going to assume that it would not be released in case of the bank's default—that is, Worthen's default. The insurance company could look back to the plaintiff.

All right.

By Mr. Sayre:

Q. Mr. Penick, we have been over the description of how the option price was determined and that an investor would put in 6 percent—excuse me—would put in $500,000.00 and receive six percent on that if and when the option were exercised. I believe you have been in the courtroom and heard the argument or statements of counsel, and the question was asked you on direct examination that the government theory of the case is that, in effect, Mr. Lyon's company has made a $500,000.00 loan at the rate of six percent. And your statement was that you could not understand that under any accounting or tax theories; was that correct? A. That's correct.

Q. You do not understand that the government would treat the $500,000.00 investment of Frank Lyon Company as a loan to the bank to be repaid at six percent interest in accordance with the statement in Plaintiff's Exhibit

No. 13, which is the specifications of the bank if and when the option were exercised? [327] A. I don't understand how the government's theory could say it's a loan. It is clear throughout the specifications treated as an equity investment. No theory of accounting and economics could develop—you'd have to go way far out to develop that equity investment in real estate as a loan.

Q. Or would have to ignore the form of the transaction and consider that in substance it was a loan with a return on that loan of six percent.

The Court: Since we are really arguing for the benefit of the Court—and that's practically what we are doing throughout the trial because essentially most of the facts are undisputed—let's just ignore all form and just try to find out in terms of a loan. A loan of so much money usually requires it be repaid usually at a certain time or usually requires or has incident to it a payement of interest that is required to be paid by the borrower.

Now is there in this transaction, disregarding all substance, any obligation to repay the loan or any obligation to pay the interest—legal obligation that you call interest?

Mr. Sayre: Are you referring to me or the witness?

The Court: We are arguing the case, it seems to me, and I want to get right to it.

By Mr. Sayre:

Q. Mr. Penick, let me ask you if the obligation of the [328] bank would be to pay the option price if the bank exercised the option.

The Court: That's quite clear. I am doing my best to do what you suggested and disregard everything and find out if there is an obligation to repay the so-called loan. Every loan I have ever heard about is that every loan requires at some time it be repaid. Most of them require an interest

rate and that's what the government is saying it is and it is required to be paid at a certain time.

Is there any legal obligation in connection with any of these agreements, however you characterize them, for the repayment of the so-called loan or for the payment of interest that is not dependent entirely upon the exercise of the independent judgment of the bank as to——

Mr. Sayre: I believe they are dependent upon the exercise of the option.

The Court: In other words, if the "lender", Frank Lyon, wants to gets its money back and its interest at any time, how can it do it? Is there any way it can do it legally, force—

Mr. Sayre: On the exercise of the option. That would be the decision of the bank. That's correct.

By Mr. Sayre:

Q. The bank, you said, has not made a decision whether or not the exercise these options; is that correct? [329] A. That's correct.

Q. In other words, the decision of the bank will come at the time each option occurs? A. Yes.

Q. And you stated that under those reports a certain amount of capital would be projected to be needed over the next five years? A. Five years.

Q. And also that the bank in the last two or three years has doubled its capital; is that correct? From— A. Doubled its capital stock, yes. Five to ten million.

Q. So as you describe the bank went outside and got the capital to—from FABCO. FABCO went outside the bank to get the capital? A. Yes.

Q. In a two-year period the bank doubled its capital?

Now in Plaintiff's Exhibit 46 there was a—This is going beyond 25 years, the first 25 years of the loan or the least period covered by the loan, and if all the transactions occur

as stated in the lease and the bank continues to maintain its ten point one percent return, the bank would have a probably or a possible gain of a little over $5 million by not exercising the option; is that correct? A. That's correct.

[330] Assuming the fair market value of the building is about $2 million at that time, two million one.

Now if the inflationary spiral we have been living in over the last few years, the inflation that has occurred in this country, say, for the last 50 to 60 years, and the price—fair market value of the building was, say five to seven million dollars at 25 years from the date, would the bank exercise its option to purchase the building for two million one if it had an asset that it could acquire that was worth two or three times that much? A. Well, I think you'd—it would be mere speculation in trying to look 25 years down the road.

Q. It's mere speculation looking 25 years down the road on this; is that right? A. I think the only thing—this is what we know or we feel we can do. I think the only thing that is speculative here is can we maintain ten point one percent return on capital. That's the only factor in there that's the unknown.

Q. Assuming that the bank building would be worth $5 million and you could buy it for $2.1 million, $2,145,000.00, the bank could exercise the option, purchase the building and then if it didn't want to stay there it could actually sell the building and realize the appreciation in gain or the appreciation in the value, building itself, rather than the Frank Lyon Company recognizing that. [331] A. Yes, it could.

The Court: Aren't you saying, Mr. Sayre, that the bank cannot make, certainly, the best judgment as to what is in its best interest until the last minute?

Mr. Sayre: Until the time the options come due; that's correct.

The Court: And economic circumstances can change materially and alter the basis for a decision that can be predicated at this time?

Mr. Sayre: That is correct, Your Honor.

By Mr. Sayre:

Q. The guaranty or the option to repurchase on Frank Lyon's outside agreement, Plaintiff's Exhibit No. 50, there is an agreement that if Frank Lyon Company is sold that the bank has the right to purchase the building or to find a nominee to purchase the building acceptable to it. Is that the bank's understanding? A. I think this letter is an indication that Frank Lyon will see that the bank's interests are protected and that an owner of the building acceptable to us is made available.

Q. And in other words, a substitution of another company acceptable to the bank for the Frank Lyon Company? A. Yes.

Q. Mr. Lyon has been—is a director? [332] A. Yes.

Q. How long has he been a director of the bank? A. Since 19—mid-1950's. I'd say probably '55.

Q. Approximately 20 years? A. Yes.

Q. Or close to 20 years?

The Worthen Bank guarantees that it will pay all of the rental for the 25 year period. In other words, whether the building is damaged or it can't be used, Worthen Bank has an outstanding obligation with no setoffs to pay that amount of rental; is that correct? A. I'm not that familiar with the total agreement, but I thought——

Q. I believe yesterday when—— A. I think Mr. Cotham testified to that.

Q. Mr. Cotham attested to that. A. Yes.

Q. Those rights are assigned then to New York Life by Frank Lyon Company and all—I think Mr. Dover said yesterday everything was assigned as security to New York Life. So New York Life as the assignee has the right to

collect the rent directly, which is an amount equal to the debt service on that mortgage in the event that they should exercise that option, and Worthen Bank has the obligation to pay that amount for 25 years; is that correct? [333] A. Yes.

Q. And again——

The Court: I guess to protect your ability to pay and cover the risks you insure as to damage to the facility?

The Witness: Yes.

The Court: Fire and so forth?

The Witness: The lease payments are not insured, Your Honor.

The Court: No. I understand that.

The Witness: Physical facilities are.

The Court: Is there any protection to you against condemnation?

The Witness: There are condemnation clauses in the provisions.

Mr. Sayre: Provision 18, Your Honor, or paragraph 18 of that provision, 17 or 18. One of them has to do with total destruction and the other one——

Mr. Giroir: Condemnation provisions roughly parallel the damage construction provision. The condemnation award being set off——

The Court: There is no way in which you would be looking to the constitution, in effect, to protect you in terms of the fair compensation as to these obligation?

Mr. Giroir: Yes, sir.

The Court: You can't really insure any other way [334] against condemnation, can you?

Mr. Giroir: We weren't able to arrive at that.

By Mr. Sayre:

Q. Now the financing was arranged by the Worthen Bank and this investor was sought. The bank has retained control of the building, not only in its inception and planning its construction, but also in the actual use of the building; is that correct? A. Yes. We rent the whole building and subrent it.

Q. And all rights of the bank and the Frank Lyon Company under these numerous agreements have been assigned to the ultimate mortgage holder, the New York Life Insurance Company. A. Yes.

Q. And if there is any problem with the bank building, any suit brought, any damage to the building by natural or fire causes or if any other risk attendant to that building is borne by the Worthen Bank; is that correct? A. I think you will probably find Frank Lyon Company joined if there was some suit brought that related to the ownership of the building.

Q. And you have granted them an indemnity against any judgment? A. Arising out of the occupancy and use of the building.

Q. Under the lease. So that, in effect, for the life [335] of that lease the ultimate risk of the operation of the building lies with the Worthen Bank; is that correct? A. Yes, sir.

Mr. Sayre: No further questions, Your Honor.

The Court: And I guess there could be really no net lease unless—to the lessor, unless he was guaranteed more or less against having to assume additional obligation down the line.

The Witness: Yes, sir.

The Court: So this is part of the agreement to protect his expectancy in terms of the undertaking; is that correct?

The Witness: That's correct, plus that's the way we want it. We not only wanted the responsibility, but the authority. It's a two-sided arrangement.

The Court: You may stand down.

Let's see, Mr. Williamson. I am trying to make my plans here. We have Mr. Lyon and who else? An expert?

Mr. Williamson: Yes, sir. I have only two or three questions on redirect so that won't take any time.

The Court: Well, let's just be in recess an hour. I think I can't cut it down more than that.

We will be in recess until 1:30.

(Whereupon, at 12:30 p.m., the above-entitled proceedings were in recess, to reconvene at 1:30 p.m., the afternoon of the same day.)

AFTERNOON SESSION

1:30 p.m.

The Court: Redirect, Mr. Williamson.

REDIRECT EXAMINATION

By Mr. Williamson:

Q. Mr. Penick, I believe the last line of questioning that you were faced with involved government's attempt to establish that in the event of any fire or damage through Act of God down there that it would be Worthen Bank who would bear the economic burden or the loss involved, economic loss.

Would you please state whether or not you have insured against all of these contingencies? A. Yes, sir, we have insured against all contingencies and possibilities that we can insure against.

Q. So in the event of any destruction it would not be Worthen Bank but the insurance company that would bear the economic loss; is this true? A. Yes.

Q. Referring again to Plaintiff's Exhibit No. 50, I believe the government attorney asked you if the purpose of this letter was simply——

The Court: This is Plaintiff's Exhibit 50, is it not?

Mr. Williamson: Plaintiff's Exhibit 50.

The Court: I thought you said Defendant's Exhibit.

[337] By Mr. Williamson:

Q. The purpose of this letter was simply to guarantee Frank Lyon Company that—that Frank Lyon Company was simply going to guarantee to Worthen Bank that they would see that you would get an acceptable owner of the building.

Does it actually do that or would you refer again to the exhibit and state what Frank Lyon Company is really doing? A. Well, I think it is expressing the intention. The letter reads: "I will contact you to see that the bank's interest in having an acceptable owner of the building is protected. Will at that time sell the building to you or your nominee at a price which we will negotiate."

Q. And the method of protection was to sell the building to Frank Lyon Company at a negotiated price? A. Sell the building to either an acceptable owner, I believe.

Q. Or you? A. Or us.

Q. At a negotiated price? A. Yes.

Q. Can you also on cross examination, as attempted to be brought out, that it was Worthen Bank who had first picked the option to purchase as ending at the end of the 11th year. Can you refer to Plaintiff's Exhibit No. 12 and indicate [338] whether or not—from whom the idea of the 11th year option came? A. It came from Stephens, Incorporated in a comparison of the proposals that had been submitted by Goldman Sachs, Stephens and Frank Lyon.

In the Frank Lyon Company proposal it was a repurchase only at the end of the 15th year.

Q. And in Goldman Sachs they have suggested the 15th and 20th years, I believe. A. Yes, sir. I think that I testified earlier that what we did in trying to write our specifications were to pick the items of each of these proposals that were most beneficial to the bank and, of course, the option ran entirely in our favor and it would have been to our benefit to have the right to exercise that option at an earlier time.

Q. Would you now, please, refer to Defendant's Exhibit 16 and to a schedule about halfway through headed up "Stephens". A. Yes, I have it here.

Q. That schedule, again, took income on December 31, 1966; took balance on June 30, 1967, call. "Stephens had 80 percent occupancy at $4.50 per square foot."

Is that referring to this Worthen Bank Building or could that be some information obtained from Stephens in connection with Stephens' experience on its own Stephens Building? A. I think it's probably some information that they [339] solicited from Stephenson the basis of which they computed their figures.

Q. But those figures had nothing to do with Stephens' bid on this Worthen Bank Building? A. Not to my knowledge.

Q. Also on cross examination it was brought out that the government is contending that in a current examination of Worthen Bank's tax return for 1969 that the government has allowed Worthen Bank a deduction for depreciation on the building and interest paid to New York Life.

Has Worthen Bank contested that determination or agreed to it? A. We have contested it.

Q. One final question.

You referred in cross examination that you had negotiated these leases—I mean these loans on both interim and permanent financing in order to get the best rates that you could because "We would be paying the interest."

By that, just what did you mean? A. Well, we would be paying it indirectly in the form of rent over the term of the loan.

Mr. Williamson: No further questions.

RECROSS EXAMINATION

By Mr. Sayre:

Q. With regard to that last question I asked you to [340] at Defendant's Exhibit No. 11 and 12. Defendant's Exhibit No. 11 is a copy of a letter written on the stationery of the bank and signed by Mr. Frank T. McGehoe.

Who is he, please, sir? A. He was the building coordinator.

Q. It is dated November 28, 1969 to the New York Life Insurance Company. It says: "Attention Vice President, Real Estate and Mortgage Loans" and it refers, of course, to this building transaction.

"This is to certify to New York Life Insurance Company that as of October 31, 1969 the records of Worthen Bank and Trust Company show that it has paid in connection with the total cost of the mortgage property as defined in paragraph 2E of the consent and agreement dated May 1, 1968 between Worthen Bank and Trust Company and the New York Life Insurance Company as follows:"

There is a breakdown of the payment to Matson Bellows, architectural fees, construction consulting fees, interior design consulting fees, so forth. Under "other material"—on the last page it's got "legal and accounting fees and interim interest on construction funds borrowed".

Do those construction funds of $399,000.00 pertain to money borrowed on the building itself? A. I would assume that they do. I'm not exactly familiar with it.

[341] Q. If the testimony has been that Frank Lyon Company has paid—drawn the money down and paid it,

why would the bank certify in this letter to New York Life in accord with the agreement and—consent and agreement which is an exhibit here—that it had paid this interim interest? A. Well, I think this letter dealt with the requirement of the New York Life Insurance Company in the final closing and certification from us as to exactly the total cost that had gone into the building.

Q. Then what you are saying is that—— A. I think it is a mistake in the way it is written because the total cost in the building and these—the interim construction loan ran to the Frank Lyon Company.

Q. Now we talked about the interest was arranged, or the terms of the loans were arranged by Worthen Bank prior to the time that even Frank Lyon Company, had got into this arrangement. Because you said the bank would be paying the interest indirectly through the rent; is that correct? A. Right.

Q. What about the same agreement was made with regard to the interim interest, the interest on the interim loan? A. I'm not sure whether we paid the interest on the interim loans or not. We did not. I'm——

Q. Then the total amount of miscellaneous expenses claimed with regard to the building: this is fees of the [342] accountant and attorneys under the various agreements and the claim for interim interest to Frank Lyon, approximates $500,000.00.

Was it contemplated that the $500,000.00 that Frank Lyon was going to put into the venture would cover expenses? A. No. There was no inter-relation between those two at all.

Q. It's just coincidence? A. If it turned out that way it is coincidence.

Q. And on Exhibit No. 12, which is the independent certified accounting firm of Cotham, Wyman and Howland also certifying to New York Life that the interim interest on the construction loans were paid, that was, again—it was

not paid by Worthen Bank and that is a mistake in the certification? A. Well, I don't know exactly how the books were handled on that. These certificates were not so much how they were paid but what the total cost went into the building.

Q. You stated that the Worthen Bank had covered its risk, ultimate risk with regard to damage or repair or anything to do with the operation of the building is borne by Worthen Bank rather than Frank Lyon Company; is that correct? A. Through the insurance.

[343] Q. Then the insurance premiums that go into this are paid for by Worthen Bank; is that correct? A. That's correct.

Q. Now you stated that the bank had contested the treatment made by the Internal Revenue Service. Before lunch you said you didn't know what treatment had been made. Have you checked since that time? A. Yes.

Q. The Internal Revenue Service has allowed the bank a depreciation deduction and an interest deduction for the New York Life loan; is that correct? A. I checked on whether or not we had contested it and I have the comptroller of the bank who would speak to that better than I could.

The Court: It is immaterial whether the IRS is being consistent with another taxpayer or not. I am assuming that it is.

Mr. Sayre: I have no further questions, Your Honor.

Mr. Williamson: May I just ask one further question?

FURTHER REDIRECT EXAMINATION

By Mr. Williamson:

Q. Referring again to Defendant's Exhibit 12, prepared by the certified public accountant firm of Cotham, Wyman and Howland, as stated in the letter itself pursuant to paragraph 25 of the consent and agreement, under that

particular [344] agreement, consent and agreement between Worthen Bank and New York Life, that paragraph 2E required the accounting firm to certify as to the total cost of the building, not who paid for it. A. Yes, sir.

Q. And this certificate is being made pursuant to that. A. Total dollar amount that went into the building.

Q. And in showing that the interim interest on construction funds borrowed were paid in the amount of three ninety-nine and legal and accounting fees paid in the amount of $53,000.00, is not a certification that Worthen Bank paid them is it? A. It is not intended to be.

The Court: Did Worthen pay them?

The Witness: Sir?

The Court: Did Worthen pay them?

The Witness: No. Frank Lyon Company paid.

The Court: All you paid Frank Lyon so far is a rent—you call a rent, and the government calls interest. At least it equals the amount of the obligation to the New York Life?

The Witness: Yes, sir.

The Court: And if anything else was paid it was not paid by Worthen?

The Witness: That's right. Yes, sir.

[345] The Court: I am just talking about dollars. I assume these bills were paid by somebody: the interim interest and the legal expenses and the bills, I think it is undisputed they came out of the bank account of the plaintiff, is it not?

Mr. Williamson: That's correct.

The Court: And they weren't indirectly paid in the sense that nothing in excess of the rental payments were paid by Worthen Bank to the plaintiff.

The Witness: This is a requirement by the New York Life Insurance Company as to the total cost of the building. We had to certify as to the total cost of the building, not who paid it.

By Mr. Williamson:

Q. And, of course, Mr. Cotham has already testified that Frank Lyon Company paid for the interim interest monthly out of its own fund? A. Yes, sir.

Q. Consequently, in Defendant's Exhibit No. 11, in which Frank McGhee—would you explain who Frank McGhee was in connection with this project? A. Frank McGhee was the Worthen Bank staff member who carried the responsibility as building coordinator, who coordinated all aspects of the building and to be in charge of renting the building.

Q. As I understand it, the loan agreement also required [346] Worthen Bank to certify as to the cost of the building. A. Yes, sir.

Q. So in this DX 11 in which Frank McGhee is certifying that Worthen paid these costs to the extent that he is certifying that Worthen paid the interim interest and the legal and accounting fees, it is simply an error, is it not? A. Yes, sir.

Q. Really what he should have said is that the total cost of the building was this, not that Worthen paid this amount; is that correct? A. That's correct.

Q. And only to that extent is this certification of McGhee in error? A. Yes.

Mr. Williamson: No further questions.

The Court: All right, Mr. Penick, I think they are going to let you go.

(Witness excused.)

The Court: Call your next witness.

Mr. Williamson: Mr. Cotton Barnes.

The Court: Mr. Barnes, come forward, raise your right hand and be sworn.

Thereupon,

C. V. Barnes

[347] having been called as a witness by and on behalf of plaintiff, and having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

By Mr. Williamson:

Q. Would you please state your name and address? A. C. V. Barnes, 22 Wingate Drive, Little Rock, Arkansas.

Q. How old are you, Mr. Barnes? A. How old am I?

Q. Yes. A. Fifty-seven.

Q. Fifty? A. Seven.

Q. What is your occupation and present employment? A. I'm a realtor, real estate counselor.

Q. How long have you been engaged in the real estate business? A. About 25 years.

Q. With what firm are you presently associated? A. Barnes, Quinn, Flake and Anderson.

Q. What is your position with that firm? A. President.

Q. What higher education did you have after high school years, Mr. Barnes? [348] A. I attended Little Rock Junior College and Oklahoma State College.

Q. How long have you been a real estate appraiser? A. About 20 years.

Q. Of what professional associations are you a member? A. Well, a member of the American Society of Real Estate Counselors. I'm a senior member of the National Association of Independent Fee Appraisers. I belong to the local, state and national association of realtors.

Q. Incidentally, how many members are there in this American Society of Real Estate Counselors? A. There are about 430 members, I believe, nationwide.

Q. How many in Arkansas? A. Four.

Q. Have you in your professional career served as an official appraiser or designated appraiser for any government agencies? A. Veterans Administration, General Services Administration at the federal level. At the state level almost any state—well, that's not literally true—but a whole lot of the state agencies. City of Little Rock, housing authorities of both Little Rock and North Little Rock.

Q. Have you been appointed in any official position as a member of a federal land commission appointed by Judge Henley? [349] A. Yes, sir, I served as a member of a federal land commission on properties on the Cadron Creek under appointment by Judge Henley several years ago.

Q. Mr. Barnes, without going into any great detail, would you simply explain the more common methods of financing real estate need for someone who wants a building? How would he go about the various methods he would use to meet those needs. A. By financing—I'm assuming you are speaking in the broad generic sense of how you would go about arranging for all of the money necessary, whether by a loan or by other methods.

Q. That is correct. That's what I mean when I talk about financing arrangements. A. Of course, the simplest arrangement would be for an owner to just make a direct mortgage for a part of the money with a balance of the money being equity put up on the part of the owner. That's the simplest form I presume.

But today, particularly on larger type developments, it's unusual to find a development that's done on that simple premise. Generally, they use a multiple of different methods. They will probably start off with a ground lease and then it could—the leasehold could be mortgaged and lessor's interest could be mortgaged. You can just take it about as many steps as you want to take it.

[350] Q. What generally dictates the particular form in which a financing of a real estate venture occurs? A. The form that's most favorable to the developer.

Q. Is it unique in real estate investment that a potential tenant would want to build himself a facility and then sell it and lease it back? A. No, sir. Particularly among national concerns this is probably more nearly the pattern than the other way around. People like Safeway stores, IBM and other national concerns will get the control of the property, build the property, may or may not arrange for the financing—some do and some don't—and then when it's all said and done sell it and lease it back or have a prearranged agreement before they do it to sell it and lease it back.

But the main thing is that anyone like that wants to keep control of the development all the way through.

Q. Why does he want to keep control of the development? A. Well, he wants to keep control of the development because he's going to be the user of the property and he wants to be assured that what—the end result meets his needs.

Q. But then when he sells the property, does this mean that he hasn't really disposed of the ownership even though he may lease it back?

[351] Mr. Sayre: I object to that. It is a legal determination.

The Court: I think the objection is proper.

By Mr. Williamson:

Q. Mr. Barnes, you mentioned Safeway as a national concern that frequently uses a sale leaseback. Are you familiar with the Safeway sale leaseback forms? A. Yes, sir.

Q. Have you ever been involved in any sale leaseback transaction representing the property owner in your own experience? A. Yes, sir.

Q. The plaintiff has already introduced as exhibits in this case a particular transaction involving a T. M. Mayer and Safeway. Is that his name? A. It's Teddy Mayer and Nick Mayer.

Q. Without going into any great detail in that transaction, would you explain who the Mayers were and just how the transaction developed and what the terms were? A. Well, the Mayers are—well, I should say, I guess, were local residents of Little Rock. One of them has since moved outside the city. They owned property at Markham and Rodney Parham Road. They retained me as their agent to see about leasing the property. I made a ground lease with Safeway Stores and with Magic Mart. Safeway Stores, after [352] executing a ground lease——

Q. Just briefly, what were the terms of the ground lease?

Mr. Sayre: Again, I'm going to object as I did at the start to the introduction of the specific document into evidence and the testimony about the specific transactions which has nothing to do with our transaction under the sale and leaseback. He obviously is a realtor and an expert as a realtor. If he has knowledge generally, he can testify, but I don't think as to specific transactions that they have anything to do with the specific terms that we have here and, therefore, it is immaterial to this action.

Mr. Williamson: Your Honor, I think it is material for this reason: Safeway is one of the pioneers in this whole field of sale leaseback. This arrangement he has is a typical Safeway—they call their program buy, build, sale and lease program. They had a whole setup for this. It parallels this situation almost exactly and I would like to show that this is a very widely used device and well known to all realtors of a type of financing which is recognized by the government as a true sale leaseback.

The government allows Safeway the rental deduction. It allows the investor the depreciation and the deduction for the depreciation. It is just simply a typical sale leaseback transaction in the general real estate trade and then draw [353] parallels between that situation and this, which are

almost identical on the face of it except for the dollars involved.

Mr. Sayre: Your Honor, we have not had any evidence or testimony of whether or not Safeway leases have been challenged by the Internal Revenue Service. We'd be more than willing to stipulate that sales and leasebacks are ways of financing construction and in the letter I believe of Eastman Dillon which is in evidence, they have stated they have placed "X" million dollars in sale and leaseback financing, but I don't think any particular transaction with regard to a Safeway store here in Little Rock has anything to do with the issue in the suit with regard to this particular taxpayer as the cases have shown which both plaintiff and defendant have cited. The facts in each one vary and are slightly different.

I don't think this Safeway transaction, which to my understanding was never even culminated——

Mr. Williamson: It was culminated, Your Honor, and the testimony will bring this out.

The Court: Of course, I think the objection really is well taken. Whether or not this type of transaction has been used by others, whether or not the government has accepted it would not prevent them from challenging it. Of course, the Court is very much interested in what there is in the usual situation that satisfies the government and how this [354] one differs-and makes it unsatisfactory.

I am going to receive it subject to the objection because I want to inquire of him as an expert as to certain elements, see if I can find out the critical elements that are involved for tax purposes. So I will receive it subject to the objection.

By Mr. Williamson:

Q. Now you say Mr. Mayer first entered into a ground lease with Safeway? A. Yes, sir.

Q. Did Safeway first try to buy the land? A. Yes, sir. It was not for sale.

Q. So Safeway leased it and for what period of time? A. I'd have to refer to the lease. As I recall, the lease option covers 65 years.

Q. You can give him Plaintiff's Exhibit 47. A. The original term was for 20 years.

Q. And how many renewal options were there? A. Six, five-year ones, if I remember right.

Q. And did Safeway have the right to construct a building? A. Yes, sir.

Q. What provision was made with reference to any right of first refusal if Mayer wanted to sell the land or first refusal if Safeway wanted to sell the building? [355] A. They each had refusal options of the other.

Q. Well, the Safeway then proceeded to build the building. Was it the practice of Safeway to sell these buildings? A. Yes, sir.

Q. And pursuant to the right of first refusal, did Safeway offer to sell the built building to Mr. Mayer? A. Yes, sir.

Q. Would you refer to Plaintiff's Exhibit No. 48 and say on what terms was this investment offered to Mr. Mayer? A. Well, in May of 1969 it was tendered on a basis of a nine point four nine constant.

Q. Would you explain just what that means? A. Well, what it meant was that over a 20 year original period Safeway would pay rental equal to point zero nine four nine times the purchase price.

Q. Would you state whether or not it was a net lease? A. It was a net lease.

Q. And by that you mean what? A. That the lessee, Safeway, would pay all expenses. The money received by the lessor would be net. There would be no expenses for him to pay out of his receipts other than income tax.

Q. Now were there any renewal options? [356] A. Yes, sir, they had six, five year renewal options at a constant of three percent.

Q. That is the annual rent would be three percent of the sale price? A. Three percent of the original sale price, correct.

Q. Were there any options to purchase the property? A. Options to purchase?

Q. Or cancel the lease. A. Well, in the event that Safeway should abandon operation of the store, Safeway would have the option to purchase the property back. A. What what was the option price? A. The unamortized—in effect, this zero nine four nine being a constant is set up to return the purchase price plus a rate of return on the money.

Q. And what was that? A. The repurchase price was the unamortized portion based on that constant.

Q. Did you look into that proposal and attempt to advise Mr. Mayer on whether or not he ought to make this investment? A. I did.

Q. And in advising him, what computations did you make? A. Well, I made an analysis based on what the after [357] tax effect would be of making this transaction. My advice was that at that time the lease that he should sell it on was a ten point zero four constant.

Q. Then so he refused this offer? A. That's right.

Q. Refer now to Plaintiff's Exhibit 49. Would you state what happened with reference to the property? Was Safeway able to sell the property on the original terms? A. No, sir, not on the terms that were tendered in 1969.

Q. What happened in July of '71? A. Well, in July of 1971 we were advised that Safeway did have a buyer for the property on somewhat the same terms as the original in that there would be an original term of 20 years with renewal options at a constant of ten point two five.

Q. As opposed to the original proposed rent of what? A. The original proposal was nine point four nine.

Q. And what about the rental during the renewal option period? A. The renewal option period in the '71 proposal was a five percent as opposed to three percent originally.

Q. Did this proposal also contain an option to cancel the lease should the buyer want to abandon that site—— A. Yes, sir.

Q. —and purchase it? [358] A. It had an option so that Safeway could repurchase the property.

Q. And at what price? A. It was, again, on a schedule based on amortization of the purchase price.

Q. Incidentally, this is the original cost of the building, amortization of the original? A. Well, the proposed sale price in both instances is $235,000.00 which was Safeway's initial cost in the property.

Q. Just in the building excluding the land? A. Building and other improvements built on the land.

Q. Did you again make an analysis of this particular proposal? A. Yes, sir.

Q. And in connection with the analysis, did you figure —how did you treat the depreciation insofar as an investor was concerned in figuring the income strength? A. Well, again, I analyzed it on an after tax basis figuring that——

Q. Who would be entitled—— A. —if Mr. Mayer purchased the property or any other investor purchased it from Safeway that they would be the owner of the property and would be entitled under applicable regulations to take depreciation on the property.

[359] Q. Did Mr. Mayer buy this particular property? A. No, sir.

Q. Do you know whether or not it was sold on these terms? A. Yes, sir, it was sold on these terms.

Q. Have you analyzed the transaction and documents in the sale leaseback transaction between Frank Lyon Company and Worthen Bank and Trust Company? A. I have.

Q. Did you see anything unusual in a sale leaseback arrangement and the fact that the bank in this particular case selected the architect and the contractor, the building con-

sultant and supervised the building of the building? A. Nothing at all unusual.

Q. Are you aware of other national concerns, even other than Safeway, who enter into this type of transaction? A. Well, I think IBM does it. Other banks in Little Rock have done it. Not in the case of a sale leaseback, but they have controlled the situation where other forms of quote, unquote financing have been used like limited partnerships and things of that kind.

Q. Incidentally, did you put together the financing in our term of the financing arrangements of First National Bank Building that's going up almost next door here? A. Together with my associates, yes, sir.

[360] Q. In that particular case, would you briefly explain without going into details and vis-a-vis this particular point who the owner is going to be and who actually did all of the work in connection with employment of contractors and so forth? A. Well, in effect, the bank has been in full control of the operation from its inception. We have served as their agent in first acquiring options on the property to get control of it and ultimately purchasing the property; and the bank has, in effect, let the contracts with the architects, the contractors and the other people involved in the transaction. The bank itself will not be the owner of the property.

Q. Who will be the owner? A. A joint venture between a wholly-owned subsidiary of the bank and the National Insurance Company.

Q. And is the bank a member—is this going to be a limited partnership? A. Yes, it is a limited partnership.

Q. Who was the general partner in the partnership? A. Well, the general partner is the First National Building Company which is a wholly-owned subsidiary of the bank and Martin H. Morgan, an individual residing in Dallas, Texas.

Q. Is there any financial strength in the general [361] partner, generally speaking, of any substantial amount? A. Well, the subsidiary corporation of the bank has no substantial financial strength and in considering the size of the project the other general partner's net worth would be insignificant compared to the size of the project.

Q. Is the bank itself one of the limited partners? A. Yes, sir.

Q. Together with? A. Connecticut Mutual Insurance Company.

Q. And in that particular situation the bank made all the arrangements with reference to the contractor?

The Court: I think really to avoid the continuing objection, which is well taken by the government, let's just talk about arrangements in general as opposed to any particular one.

You have mentioned your experience with big companies: IBM, the bank, Safeway and so forth. I am trying to find out the characteristics of these arrangements. Is it characteristic that the developer is the one who contemplates having the future use of the facility?

The Witness: Not in all cases, Your Honor. Some people are the principal users and other cases the development is handled by a entrepreneur.

The Court: Who initiates the projects?

The Witness: Basically the project is initiated by [362] the—by whoever is the ultimate user.

The Court: Someone wants an office building or Safeway store or bank building——

The Witness: Yes, sir.

The Court: Now who controls the design, the architecture and decides on those issues?

The Witness: The user. The ultimate user.

The Court: Is it unusual or typical that the arrangements, in effect, that the lessor is on a net basis and does not incur any obligation with respect to maintenance, repair, management, operations of the property?

The Witness: In the typical sale leaseback, a net deal is by far predominant. There may be a few old ones not on a net basis, but in the last five or six years I haven't heard of one being made on anything other than a net basis.

The Court: More or less looked at it from the developer. Now from the point of view of the lessor, what are the considerations? What is he looking for?

The Witness: Well, he's looking for a facility tailor-made to meet his requirements without any investment of capital.

The Court: Well, are you still thinking—I'm not talking about the investor. The man that owns the land or the one who, in effect, leases it and has on a net basis, what is he looking for?

The Witness: You are talking about the user of the [363] property?

The Court: No, I am not talking about the user.

The Witness: The lessor?

The Court: What is he looking for out of this arrangement?

The Witness: He is looking for what he gets to put in his pocket after taxes and everything is all over with.

The Court: You were talking in terms of a rate of a percentage return on his investment; is that correct?

The Witness: Well, the figure that I gave in connection with the Safeway property is a constant which returns the capital and a rate of return. That's what an investor looks for.

The Court: Is there a difference in terms of the incentive for an investor to buy into this type of arrangement depending upon his own tax situation and his other income? Would this be equally advantageous to any other investor?

The Witness: No, sir.

The Court: So are you saying then that the total economic effect depends upon his own tax situation?

The Witness: That's correct. Under the tax laws as I understand they currently exist, a taxpayer in what we call the lower bracket does not have the incentive to invest in real estate that a taxpayer has who is in a higher bracket.

The Court: Now you have looked at these documents [364] in this case and let's say you were advising Mr. Lyon's company as to whether or not it should get into this transaction and you know the date of the transaction?

The Witness: Yeah, I think I do.

The Court: How would you analyze it for him?

The Witness: Well, I would be analyzing it on the basis of yield on his equity investment on an after tax basis.

In other words, if he is going to invest one dollar equity, what is his return going to be on that one dollar after taxes.

The Court: Do you know of any situation where the investor in this situation would enter it where he had the potential under the agreement to lose money?

The Witness: To lose money?

The Court: Yes. Where he would assume any risk loss.

The Witness: Well, I think that—I don't know of any real estate investment where there isn't a degree of risk involved and there is no guarantee that you're not going

—there's no guarantee of a profit—let's put it that way—in any real estate investment I know of.

Now the type deal Mr. Lyon and Worthen made is the type that has less risk and for that reason the rate of return, so to speak, will be less than on an investment that has a [365] high rate of risk.

Real estate is like other type of investment. The rate of return is relative to the risk.

The Court: Now most of these transactions you have described and this one here has in it several options on the part of, in effect, the lessee to buy at certain periods of time down the line.

The Witness: Yes, sir.

The Court: If they exercise those options that changes —potentially could change the economic advantage to the investor.

The Witness: When you analyze a property for this investor you analyze it based on what happens if the lessee exercises his option at whatever point in time the options are and say, "If he exercises this year your rate of return will be this much. If he exercises this year your rate of return right on down the line. If he does not exercise it here is your rate of return."

The Court: I suppose you start that discussion by saying assuming the solvency of the lessee, the least you can make on this arrangement is blank dollars?

The Witness: Well, that's correct. In a case of this particular deal where you have a fixed rental, it's not too hard to analyze. Sometimes they have—well, Safeway deals, for example, sometimes have percentage rents where you [366] can't predict was that is, but when you analyze it on the basis of what is the best you can hope to do and what is the least you can hope to do. To some extent you would do that

in a case like the one between Worthen and Lyon. Looking on down the road as to what might happen, here's the best you might hope to do; here's the worst you might hope to do. You let the client pick the point in between.

The Court: In this particular case there is the feature that the rental payments by Worthen happen to exactly equal the amount necessary to discharge the obligations to the primary lender, to New York Life.

In your experience, do you recall any agreements where investor has been willing to invest on such terms?

The Witness: I can't cite you a specific local example but it's not unusual.

The Court: All right. You may continue.

By Mr. Williamson:

Q. In determining how much before tax cash flow, does the amount of the equity invested by the investor have anything to do with what the before tax cash flow—what before tax cash flow he might expect? A. I don't know of very many investors who are really concerned about before tax cash flow. What they are interested in is after tax cash flow.

Q. If his equity investment is very low, it is not [367] unusual for there to be no positive cash flow before taxes. A. Irrespective of the equity, it's not unusual in different types of transactions for there to be no before tax cash flow. A good example are the 236 projects, housing projects, permitted under the statute by the federal government for low cost housing. The ones that I have analyzed for clients, I have yet to find one that has a before tax cash flow.

Q. And what about the prospect of the investor never getting his principal back in those investments? A. Well, again the only way that an investor in those 236's gets any return at all is from the favorable tax regulations which permit accelerated depreciation, and so on and so forth.

Q. Now looking at the actual rent that was paid in this case, which did equal exact amount of the payment to amortize the permanent loan over a 25 year period, would you, please, speak to whether or not in your opinion those dollar amounts paid in this particular case were reasonable rent? A. In my opinion the lease rental specified was a reasonable rent for the property.

Q. And would you develop that a little further as to how it came out, how you figured this? A. Well, according to my analysis, the first 11 years of the lease the rental was a net rent of two dollars and 67 [368] cents a square foot, and the last 14 years of the primary term, the rental was two dollars 81 cents per square foot. But, of course, that is a net rental, number one. Number two, it is for the entire building, no exceptions with a hundred percent rental, no vacancy or presumably no credit losses.

If you add to that the cost of operation for a building of that type, taxes, insurances, housekeeping and all of the types of things which would figure two dollars to two and a quarter a square foot, then the square foot rental rates relates favorably to the rental rates being charged in other comparable office buildings.

The Court: Maybe you can just tell me without proof in this case. The building that the plaintiff owned and leased to Worthen was not finished for tenants, was it, in the sense that I got the drift of the testimony, at least, it might not have been partitions in the rental spaces, and this would be something Worthen would work out and subleases with its own tenants. Am I correct or not? Was it finished in the sense that all the offices and all the spaces in the building were ready for rental to someone else?

Mr. Williamson: It was finished in the sense that it had walls up, partitions and so on, but it did not—if someone wanted walnut paneling or any special built-in desk, table or so forth, it was not finished. This would be, again, in

connection with the negotiations with the tenant. Worthen [369] may do that or the tenant may do that. It may be leasehold improvements of the tenant himself, depending on the amount of rent the subtenant would pay.

The Court: Were partitions there before you had a tenant?

Mr. Sayre: I think with regard to that, what you are asking is whether or not the building was completed and walled on the inside as it went up. The leasehold improvements that the bank put in of a million and a half dollars or so was done contemporaneously with the outside of the building so when completed you didn't have to go back and put the floors in. It was done contemporaneously with the shell of the building.

Mr. Giroir: The building was completed on an exterior and interior outside walls, and the flooring structure was completed; but the particular type of floor and the particular type of partition and any other of the interior improvements were only constructed as needed. Obviously, the lower floors that were to be utilized by the banks were completed first and almost simultaneously with the completion of the building. Thereafter, it was more or less a shell building.

The Court: So what Frank Lyon Company was leasing to Worthen was essentially a shell?

Mr. Giroir: With all the mechanical, electrical [370] and structural components, but not the interior.

Mr. Sayre: Since there is some dispute, may we recall Mr. Penick to clear that up?

The Court: If it does turn out there is any dispute. I was trying to make it with relation to Mr. Barnes' testimony as to what a reasonable rental would be on the local market. I wanted to know what he was renting, what he was thinking about.

Let me ask: Mr. Penick has been under oath. Just stand right there and tell me now. I know you put over a million dollars in terms of improvements in this. Are those improvements not only improvements of the facilities that the bank uses and the floors and lease space the bank uses, but also facilities that you have made for your own tenants at their requests and as part of your arrangements with them?

Mr. Penick: Yes, sir, which would be recaptured in the rent from the tenant. If a tenant was going to lease a whole floor, he had certain tenant allowances. He could have a certain quality of carpet, certain type of paneling. We would pay for so many lineal feet of partitions. Anything over that, he would have to pay for. For example, one tenant wanted a floor and a half and wanted to join the floors by an interior stairwell. They paid for that by an increase in rent and that went onto our books as leasehold improvements, which we will recapture in the rent to the particular tenants.

[371] The Court: What did you rent from the Frank Lyon Company? Before you spent any of the million plus money on the building, what did you have?

Mr. Pennick: Certified in that list about a total in our building of $7.6 million, which was a functional building: exterior walls, lights, heating and airconditioning, but not detailed tenant improvements except in some of the areas we were occupying. Basically, it was $7.6 million bank building and high-rise building.

Mr. Sayre: Mr. Penick, with regard—you said at the time you got to move in, ready to move in, it was 90 percent leased or committed; is that correct?

Mr. Penick: Letters of intent.

Mr. Sayre: At that time did people start moving into the building about the time you did?

Mr. Penick: No. I would say they started moving in two or three months after.

Mr. Sayre: This would have been in January or February?

Mr. Penick: Of 1970.

Mr. Sayre: At that time their spaces were starting to become available. In other words, partitions had been put in, their rug, and this type of thing?

Mr. Penick: Yes.

Mr. Sayre: A short delay before——

[372] Mr. Penick: Two to six months.

Mr. Sayre: How long was it before your building was rented to the point you are talking about, the 90 percent or the initial rent period? How long did it take to get the tenants in?

Mr. Penick: By mid-1970.

Mr. Sayre: Six months?

Mr. Penick: Yes.

The Court: I think my contention was right in the beginning as to what the Lyon Company is leasing to Worthen.

Do you understand what it is that they are leasing when you are calculating these rents, Mr. Barnes?

The Witness: I think I do, yes, but, Judge, let me say this: Again, this is a general practice in the industry. When you make a lease or sale leaseback you have to have some number on which the negotiations take place over. It's very common in build-to-suit property for the parties to agree on a dollar figure and then for the lessee to pick up any additional expense in the form of leasehold improvements.

The Court: All right.

By Mr. Williamson:

Q. And in the light of those facts that have just been disclosed through the question and answer period, is it still your opinion that the rent being paid by Worthen Bank to Frank [373] Lyon Company for the property they were renting was a reasonable rent? A. Yes, sir.

Q. In the light of the then market? A. Yes, sir.

Q. Some discussion has come up with respect to the ground lease only $50.00 a year for the first 25 years. Do you consider this unusual? A. Well, if the ground rent had been a fair market rental it would just have meant they would have had to increase the rental on the leaseback.

Q. Turning now to the option prices, would you comment on what percentage the various option prices were at the various option periods, what percentage of total cost, and whether or not in your opinion these were unusual in these types of transactions? A. Well, the 1980 option was at 82.79 percent.

Q. Of the cost? A. Of the original acquisition cost.

The Court: What transaction are you talking about?

The Witness: We are talking about the option price at which Worthen may repurchase the property.

The Court: All right.

The Witness: In 1980 they have the option to repurchase at 82.79 percent of the purchase price. In 1984 [374] it's 71.11 percent; in 1989 at 54.81 percent and in 1994 at 28.09 percent. Those periods are 11, 15, 20 and 25 years after the inception date of the transaction.

By Mr. Williamson:

Q. Would you comment as to whether or not there is anything unusual about those particular option prices? A. I don't believe there are.

Q. Is this type of way in estimating option prices usual in transactions of this sort? Are these out of line with the

usual sale and leaseback transaction? A. Not in my opinion, no, sir.

Q. Is there any way to accurately estimate the fair market value of just the building now, not counting the land which is not involved here, 25 years from now? A. Well, of course, presumably that's possibly what they were trying to do when they set these option prices I'm sure. Of course, when you get to talking about what something is going to be worth 25 years from now, are you going to be talking in 1968 dollars or are you talking in 1974 dollars or are you talking in 1994 dollars?

I mean, you know, how do you define it?

Q. What would be the various considerations that would go into considering what might be the value of that Worthen Building 25 years from now vis-a-vis obsolescence? A. Well, I think the principal thing that would go into [375] determining its value at that time, 1994, 20 years from now, is its functional obsolescence, not its physical situation.

I know in my lifetime I have seen three of the downtown banks move three times, all three of them—well, will be when First National moves. And also in my lifetime observing the office buildings in the community, surely the Boyle Building down here at Fifth and Main was built right after the turn of the century, but by the same token those buildings that were built about that time after they were some 25 or 30 years old they had to have extensive money spent on them to cure a physical problem, and certain functional problems you couldn't cure. So the result is that that type of age building rents for less money, which results in the value being less than it would if you could rent it for what a class A building would rent for.

Q. Is there anything unusual in your experience that the parking facility next to an office building would be under a different ownership than the office building itself? A. Some are and some aren't. In fact, I'd say there is

only one in Little Rock, I guess, where it is the same ownership and that's the Union Bank Building. The old Worthen Bank property, they did not own the parking deck behind it. The parking deck that was built next to the Tower Building. Of course, in this particular case there is an actual difference in ownership [376] although the property is under the control of the same owner.

Q. From the point of view of a real estate investment counselor and looking at these documents and knowing the transaction as you do, in advising an investor, who would you consider to be the owner of the building?

Mr. Sayre: I renew my objection.

The Court: I will sustain the objection.

By Mr. Williamson:

Q. Let me ask you this question: If this property had been offered to you to find an investor who would enter into this transaction, do you think you would have any difficulty in finding a group of investors who would have bought the building on the same terms? A. I think in 1968 I could have sold the building on the same terms and conditions to a group of investors.

Mr. Williamson: No further questions, Your Honor.

The Court: Mr. Sayre, you may cross examine.

Cross Examination

By Mr. Sayre:

Q. Mr. Barnes, you said you were familiar generally with the financing methods and sale and leasebacks. Have you ever been in on a transaction where sale and leaseback was consummated? A. A consummated deal?

Q. Yes. [377] A. No, sir.

Q. And what were the reasons that you advised the people on the Safeway deal not to get into the transaction?

You said they should not buy it except on a constant of 10.5, something like that, and it was offered on 9.34. A. Rate of return.

Q. Their rate of return would not have been sufficient? A. The rate of return at that time. It ultimately sold at a rate of return that was higher than ten zero four.

Q. And, again, you advised the client not to invest in it at that price because of the rate of return? A. Well, that's right. Now wait a minute. I don't think that's quite right. I think the second time around the client is the one who decided he didn't want to get involved.

Q. The rate of return on the Worthen Building was six and three-quarters; is that correct? A. No, sir. That was the mortgage interest rate.

Q. And the payment of rental which would cover that was exactly the same; is that correct? A. No, sir.

Q. The rental was not equal to the mortgage? A. The rental payments start out less than the mortgage payment, if I remember correctly.

Q. I don't believe you remember correctly.

The Court: The first, five years, I guess you could [378] say that.

The Witness: That's what I had reference to, Judge.

By Mr. Sayre:

Q. What are you referring to? A. As I understand it, the first five years there was $21,000.00 a year less annual rental than the annual debt service on the mortgage.

Q. Have you checked the instrument to see if that was the case? A. Sir? That's the way I read it.

Q. You read the building lease, Plaintiff's Exhibit No. 19, I believe.

The Court: Mr. Sayre, there is no sense in pursuing it. We know what the situation is. The amount is paid, but I don't know it is incorrect for him to so testify. Even at that stage of the record it would not support such a view. The

bank and the representative of the Lyon Company have indicated they acknowledge this obligation as a part of the original transaction so I suppose that is one way of looking at it: that it has the effect of reducing the amounts below the actual amount necessary during the first five years.

By Mr. Sayre:

Q. Mr. Barnes, the original offer of Frank Lyon Company called for a payment of $21,000.00 less than the mortgage [379] payment for the first five years. The New York Life Insurance Company requested and required that the payment be equal to the debt service. The rentals that have been paid are equal to the debt service. On that basis there is no before tax cash flow is that correct? A. On that basis there would be no before tax cash flow; that's correct.

Q. And you said a higher bracket taxpayer would have incentive to get into an investment such as this but not a lower bracket taxpayer; is that correct? A. The higher the bracket the more incentive.

Q. And that being that the main purpose or the main incentive there would be the ability to write off other income from other sources that that individual or company or investor had against those deductions that come from the interest and accelerated depreciation; is that correct? A. I presume so, yes, sir.

Q. In your examination is that the way you would look at is? A. Any higher bracket real estate investor then or now is looking at what he gets to keep after taxes.

Q. And since there's no before tax cash flow, what he's buying then is the shelter; is that correct, of other income? A. He may or may not be depending on the property, yes, [380] sir. It's not at all unusual then or now for an investor to buy "tax shelter".

Q. In this instance the Frank Lyon Company would not receive any before tax cash flow for the first 25 years of this transaction; is that correct? A. I have not made a projection to find out where the point is that it breaks over.

Q. Well, it's quite simple. If the mortgage payment and rental payment are equal for 25 years, there is not going to be any before tax cash flow. A. You are talking about before taxes?

Q. Yes. A. That's correct.

Q. So you are talking about a break-over point is what? A. Before tax cash flow?

Q. You are talking about an after tax cash flow, I presume, when you say you haven't computed the break-over point. A. That's correct; after tax cash flow.

Q. Would that take into consideration using the double declining balance method of depreciation? A. Using any method of depreciation? A. Using any method of depreciation permitted under the regulations and statutes.

Q. Under this type of deal it is normal to use an [381] accelerated amount of depreciation and, therefore, to create the shelter in the earlier years? A. Some investors do and some don't.

Q. In this particular transaction, that was done; is that correct? A. I'm not familiar with what accounting methods they have used to handle this transaction at all. If I were analyzing this or a similar facility for a client, I would probably present my analysis on both an accelerated and a straight line basis.

Q. You just testified that you had examined it and the matter was reasonable and that you would have been able to sell it to anybody else. Did you make your computations based upon the accelerated depreciation? A. As I state, when we analyze a property for a client we analyze it on both an accelerated and a straight line basis.

Q. And you did that here? A. I did not do it on this particular thing in detail, no, sir.

Q. And yet you have testified in your opinion it is a reasonable transaction and that you could have gotten anybody else to buy into it. A. I analyzed it to the extent I deemed necessary to be able to make that statement and I have no reservation about [382] that statement.

Q. What was your analysis and what were the elements of it? A. Well, my analysis would be what the rate of return——

Q. What was your analysis of this transaction that led you to say it's reasonable? A. Well, number one, that basically that it doesn't take any out-of-pocket cash for the deal.

Q. Excuse me. There was no investment by Mr. Lyon? A. Wait a minute. I'm talking about on an annual basis. First you had to put up a half million dollars in equity. Secondly, from then on you didn't put up anything basically, assuming the $21,000.00 a year is a nominal amount compared to the transaction.

Q. How much per year? A. Twenty-one thousand for the first five years. And, in effect, the Worthen Bank would be buying a building for the investor and at the end of 25 years the investor would definitely start beginning to get back additional monies.

Q. Now you said—— A. And this is not—you know, I didn't have to—once looking at that pattern and seeing how it worked, I didn't have to sit down and make a long projection on it to see where the various tax breaks and so on and so forth take place.

[383] Q. So you didn't make that examination? A. No, sir. I did not make that examination.

Q. Now you said, in effect, the Worthen Bank Building is being bought by the Worthen Bank for the investor; is that correct? A. Well, I said that the rent that Worthen is paying Frank Lyon is going to buy the building for Frank Lyon. That's not unusual.

Q. You know there is an option at the end of 25 years to buy the building for two point one forty-five million; is that correct, $2,145,000.00? A. $935.00.

Q. Now do you know how that option price was computed? A. How it was computed?

Q. Yes. A. I understand. I have been told how it was computed. I was not in on the original transaction.

Q. Were you told that the amount is the $500,000.00 at six percent over that period of time? A. Yes, sir, compounded.

Q. Then if the building had a value of, as you said—it amounts to the fluctuation of the dollar amount and it is kind of hard to foresee 25 years into the future as to what dollars are going to be worth. In fact, it is a little hard to see ten years into the future. [384] A. It is today.

Q. With regard to that then, if the value of that building was $5 million in 1994 or 1984, whatever the other is, '89—if the market value of that building was $5 million and the option price was less, the appreciation in value that would usually go to an owner could be taken away from Frank Lyon by the exercise of the option by Worthen Bank and the payment of what is equivalent to six percent on the money for the period of time it was used; is that correct? A. That's correct.

Q. So it would be similar to Frank Lyon loaning Worthen Bank $500,000.00 for the use of that period of time and receiving six percent on it; is that correct? A. No, sir. No, sir. Because there is no assurance that Worthen will exercise——

Q. I said if the option is exercised, it is equivalent of Frank Lyon making a loan to Worthen Bank and receiving six percent on their money; is that correct? A. Well, I don't know. I guess you could look at it that way, but it's not a loan because there is no evidence of indebtedness. What it really amounts to is that in this particular transaction Mr. Lyon was willing to invest his half million dollars in equity for a before tax yield of six percent. Now when you were trying to question me about analysis a minute ago, I was thinking in terms of a detailed [385] year-by-year analysis. I did run through. I don't think I have the figures with me. But I did run through the figures on a half million dollars' equity invested and a six percent return on the half million dollars. And then assuming a 50 percent bracket taxpayer, what the additional return

would be on that half million dollars, I came up with a pretty fantastic figure, if I remember, of a return on a half million dollars after tax of somewhere between 20 and 25 percent.

Q. After tax? A. After tax.

Q. After your depreciation deductions had been taken; is that correct? A. Yes, sir, that's correct.

Q. So in other words—— A. Permitted under the law.

Q. Well, now you are testifying as an expert on the law now? A. No, sir.

Q. Then the use of the tax benefit, accelerated depreciation, is the thing in the transaction that allows a high bracket taxpayer to achieve the incentive to invest; is that correct? A. Well, I think I'd put it another way. The present tax laws and regulations allow a high bracket taxpayer to invest at what sounds like a low before tax rate of return [386] because really what he's looking after is his after tax rate of return. And the higher the bracket he's in the more spread that there is.

Q. And the use of any deduction that he would pick up from that investment against other income; is that correct? A. Against the income from the property and if there is an excess, against other income, yes, sir. Any investor, particularly in this type of property, wouldn't think about analyzing it on anything other than an after tax basis.

Q. What are you referring to as your Section 236 housing? Is this a HUD subsidized loan? A. It's a HUD program commonly called in the industry 236 housing because it's a subsidized rental situation.

Q. Who subsidizes it? A. The government.

Q. What are the characteristics of such a transaction? A. What are the characteristics of it?

Q. That's correct. What does the government subsidize? What do they agree to do? A. Well, the government agrees to make up the difference between a certain level that a renter can afford to pay for rent and the economic rent demanded by the project.

Q. We didn't have the subsidy from the government or anybody else in this transaction we're dealing with between Worthen Bank and Frank Lyon? [387] A. I wasn't referring to the subsidy in the 236. I was referring to the fact 236 projects irrespective of the subsidy—every one that I have had any acquaintance with at all they have been buying quote, unquote tax shelter rather than a 236 project.

Q. The fair market rental of that property on which the bank building stands is worth approximately a hundred thousand dollars a year; is that correct? A. The fair market rental?

Q. Fair rental value of that property on which the bank building stands. A. Oh, the land?

Q. Yes. A. I would estimate that a hundred thousand a year would be probably a fair rental in 1968 for the land.

Q. And you're saying—— A. On a——

Q. That the rental of $50.00, if it had been a fair rental value, would have been rolled back into the transaction? A. I think any sophisticated investor would have added—let's say, if it had been a hundred thousand dollars, they would have added a hundred thousand dollars to Worthen's rent if they had had to pay a hundred thousand dollars in ground rent.

Q. Now you're saying that the fair market value of the [388] option prices was reasonable. Again, it is hard to tell what the values are going to be at any time in the future; is that correct? A. The further in the future it is the harder is is to intelligently analyze it.

Q. And it is your understanding the option prices were computed on the basis of $500,000.00 compounded at six percent; is that correct? A. It is my understanding that the option prices were the unamortized portion of the New York Life loan plus $500,000.00 plus six percent compound interest thereon.

Mr. Sayre: Thank you.

The Court: Mr. Sayre, we are going to have to be in recess here.

We will be in recess until 3:15.

(Recess.)

Mr. Sayre: Your Honor, I have no further questions at this time.

The Court: Are you through with this witness?

Mr. Williamson: Just a couple of questions.

The Court: All right.

REDIRECT EXAMINATION

By Mr. Williamson:

Q. Mr. Barnes, Mr. Sayre asked you a line of questions which suggested that he was under the impression that a [389] constant rate of ten point one that Mr. Meyer was offered on the second Safeway leaseback constituted a ten point one rate of return. Would you explain to the Court whether or not the constant that the investor was getting constituted a rate of return? A. No, sir, the constant is a factor that will return the capital together with a given rate of return.

Q. And the rate of return on a ten point one was actually the rate of return on the investor's equity, assuming the option was exercised, was what? A. I think in that case it was seven and three-quarters.

Q. But it was considerably less than the constant? A. Certainly.

Q. Second, Mr. Sayre asked you that if you assume that the option would be exercised in 25 years and if you assume that the option would be exercised in 25 years and if you assume that at the end of 25 years the value of the

building would be worth $500,000.00, in your opinion is it safe to assume that the Worthen Building would be worth —not $500,000.00—$5 million at the end of 25 years? A. First, the end of 25 years, the property is still subject to a lease. It has options to go for quite a number of years, goes to the year 2044. If you consider the rental rate specified in that lease, you'd probably find it might not even come to $2,145,935.00, if you project the value of that income stream. Of course, you don't know in the year 1994 what [390] the rate of return would be.

Q. So to an outside investor really the fair market value of that building was, in effect—be the income stream from the lease payments over the extended options? A. Right.

Q. And it's been brought out in testimony that from Frank Lyon's point of view, economically it would not make good sense for the Frank Lyon Company to exercise the option. A. For Frank Lyon to——

Q. For Worthen Bank to exercise the option? A. I don't think in 1994 it would be economic for Worthen Bank to exercise the option to purchase, because I think the rental terms on the building there after are favorable to the bank.

Mr. Williamson: No further questions.

RECROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Barnes, I don't think you have answered Mr. Williamson's question as to whether or not the building would be worth $5 million in that year. You said that it's hard to prognosticate 25 years in the future and now 20 years into the future and that it would be in terms of $68.00, $74.00 or $94.00, depending on what you are talking about.

What I was asking was if the bank building had a fair market value of $5 million at that time and appreciation

[391] in value over the 25 year life of the building that would go to Frank Lyon Company. It could be taken away from Frank Lyon Company by Worthen Bank's exercise of that option. If the building was worth $5 million that amount of appreciation could be taken away by Worthen Bank's exercise of the option of a little over $2 million; is that correct? A. Worthen Bank has got the right to exercise that option at those particular points in time whatever the building is worth.

Q. And if it was worth five million, the appreciation Frank Lyon would have realized, had there been no option, would be taken away from them; is that correct? A. What do you mean? He wouldn't have realized any appreciation at that point in time.

Q. That's correct, because— A. No, sir. In the year 1994, which I assume is the point in time we are talking about, the end of the 25 year primary term, the property is still subject to a lease, and the value of the property would be determined as subject to that lease.

Q. No. I don't think it would, Mr. Barnes, in your calculations because that lease would be canceled upon exercise of the option. Is that correct? A. Yes, but you are talking about it having a value of more than that amount. [392] Q. I said if the building had a fair market value of $5 million. We assume that as a fact. Then if the option was not exercised, Frank Lyon Company has testified that they bought it with the hope of building up an equity in the building and having a valuable downtown building.

Now if that building had appreciated in value to the point it was worth $5 million, Worthen Bank could take and exercise their option after 25 years for two million and Worthen Bank would recognize the appreciation in value, not Frank Lyon Company; is that correct? A. Yes.

Mr. Sayre: No further questions.

The Court: You may stand down, Mr. Barnes.

FURTHER REDARECT EXAMINATION

By Mr. Williamson:

Q. One other question right there. If Worthen at the end of 25 years even though the building is worth $5 million, if Worthen Bank wanted to continue to occupy it, would it make sense to Worthen to exercise the option rather than to continue to lease?

Mr. Sayre: Excuse me, Your Honor. I object to him testifying as to what Worthen would do. That's——

The Court: Both of us.

By Mr. Williamson:

Q. Is it reasonable to assume as the government did that [393] the building will be worth $5 million at the end of 25 years? A. Not subject to the lease.

Mr. Williamson: No further questions.

The Court: You may stand down, sir.

(Witness excused.)

The Court: Mr. Williamson.

Mr. Williamson: Plaintiff would like to call as its next witness Mr. Frank Lyon.

The Court: Mr. Lyon, you may testify from the wheelchair, if you wish. You can testify right there.

Please raise your right hand and be sworn. Thereupon,

Frank Lyon

having been called as a witness by and on behalf of the plaintiff and having been first duly sworn, was examined and testified as follows:

Mr. Williamson: Your Honor, during the recess—I have one other very short point I want to bring out which Mr. Ed Penick could testify and Mr. Lyon can testify to it.

As a member of the board, Mr. Penick can testify with more authority. With the permission of the government, which I have, may I have, just where Mr. Penick stands, ask him a couple more questions?

The Court: Yes, but talk loud enough for the court reporter to hear you.

[394] Mr. Williamson: Mr. Penick, has Worthen Bank engaged in any other sale leaseback?

Mr. Penick: Yes, sir, we have.

Mr. Williamson: Could you describe what they are?

Mr. Penick: We have 13 branches and they are principally relative to our use of these branches. We have, I believe, four of those 13 branches under sale and leaseback arrangements with three different parties. One party has two of the branches under sale and leaseback.

Mr. Williamson: And these are independent investors?

Mr. Penick: Independent investors.

Mr. Williamson: No further questions.

The Court: Mr. Sayre, any questions on that?

Mr. Sayre: No, Your Honor.

DIRECT EXAMINATION

By Mr. Williamson:

Q. Mr. Lyon, please state your name and address A. I'm Frank Lyon. I live at Number 9 Sunset Drive.

Q. How old are you, Mr. Lyon? A. Sixty-four.

Q. What is your present position with Frank Lyon Company? A. Chairman of the Board.

Q. You have held that position since how long? A. Since 1967, '68, along in there.

[395] Q. Who is president of the company? A. C. W. Abrams.

Q. And he has been president since? A. January 1, '67 I believe it is.

Q. Would you please state where you received any higher education? A. I attended the University of Alabama for two years.

Q. Then what did you do? A. Went to work for Reynolds Tobacco Company for a few months and then worked for General Foods for five years.

Q. In what capacity? A. Salesman first and then district manager.

Q. Then what did you do? A. Then I went to work for Gunn Distributing Company as a salesman and then became sales manager of Gunn.

Q. Then what happened? How long did you work for them? A. Five years.

Q. Then what happened? A. In 1941 Marion and I, my wife, formed a partnership to distribute Zenith television sets.

Q. Was that the beginning of the distributorship that's now Frank Lyon Company? A. Yes.

Q. When did the company incorporate? A. [396] About 1946 or '7.

Q. And at that time the sole stockholders were you and Marion? A. Yes. I believe Ollis Matigan owned one share at that time perhaps.

Q. Since that time you and Marion have been the principal stockholders, as has been testified to? A. Yes. Yes.

Q. How long have you been a director of Worthen Bank? A. Since 1953.

Q. To shorten this testimony, Mr. Lyon, I won't go over much of the testimony that's been handled—that's been gone into with reference as to how the transaction devel-

oped. I'll just ask you first in connection with how Frank Lyon became involved in this situation.

You have heard Mr. Cotham testify. Is this substantially your recollection of how it came about? A. I think it was very accurate. I will subscribe to his testimony.

Q. Mr. Lyon, were you in connection with this new building—were you on the finance committee? A. I was not on the finance committee.

Q. Were you on a building committee? A. Yes, I was on the building committee.

Q. What function did you perform in that connection? [397] A. Well, I attended all of the meetings that I was available for and I think that was most of them. I recall making a trip to see Mr. Turner who was president of First National and I called Gus Ottenheimer and Worth James. I believe we were the only three. There may have been someone else. That's where I first heard of Mr. Morse.

Q. You were over there to inquire about their experience in bank building? A. Yes.

Q. You did participate then through the building committee in the selection of Mr. Morse? A. Yes.

Q. Did you participate in the selection of the architect or the contractor through your association on the board? A. Yes.

Q. On the building committee. A. Yes. On the building committee.

Q. But in this capacity you were acting for and in behalf of the Worthen Bank as a member of the board? A. Yes, sir.

Q. Turning to Frank Lyon Company's reasons for wanting to own Worthen Building, would you briefly in your own words testify as to what your motivations were? A. I would take the different priorities than Ralph [398] Cotham testified to yesterday. My main purpose and the purpose of the corporation and people involved was diversification.

At that time we had been in business some 26 or 27 years and had no diversification whatsoever. I think that perhaps some of my associates were somewhat critical that we hadn't gotten some diversification.

Q. Some of your company employees? A. Yes.

Q. Were they urging you to diversify? A. Yes.

Q. Would you go ahead. What other reasons were there for wanting to own Worthen Building? A. We felt that we could over the years build up a good equity in the building. Of course, we did consider the tax situation. It was not the overriding in my mind, and I don't think it was in anyone else's. We never let taxes override our judgment as to what is good for us and what isn't.

Q. Ralph Cotham testified as to certain investments that you have made or at least your companies which you own or control have made in real estate, and he mentioned the one IBM Building. And I would ask you first whether or not your experience with IBM has been limited to only one building or if you own—— A. No, sir, we have got two buildings for IBM. In [399] both instances it was handled very much like the Worthen Building was handled. We didn't select the architect or had nothing to do with the construction of it. We didn't select the contractor. In fact, I don't even know when they started or stopped. We had no one in our company who——

Q. You were strictly an investor and had nothing to do with the construction of the building? A. Correct, or the design of it.

Q. Pardon? A. Or the design of it.

Q. He also mentioned a National Cash Register Building, the Stover Building, a Gibson Products Building. Now that was in? A. Springfield, Missouri.

Q. Would you please state whether or not you owned the ground in that situation? A. We do not own the ground that the building is situated upon. We have a 15 year ground lease and perhaps four, ten year options.

Q. And you built that building on leased property? A. Yes, we did.

Q. Do you have any option to purchase the ground? A. No, sir, we do not.

Q. Now can you think of any other buildings or real estate ventures in which companies of Frank Lyon have gone into [400] as an investment? A. Yes, we built the Town and Country Shopping Center. Maybe the Safeway office building was mentioned. I believe that the National Cash Register Office Building was mentioned, We have built four buildings for ourselves: one in Shreveport, Louisiana, Springfield, Missouri, one in Fort Smith, Arkansas, and one in Little Rock, Arkansas.

Q. Those buildings that are actually occupied by Frank Lyon Company as tenant in connection with your business, these consist of both an office building and a warehouse complex? A. Correct.

Q. Does Frank Lyon Company own the building? A. No, sir.

Q. Again, these are real estate companies? A. Yes, sir.

Q. And lease them to Frank Lyon? A. Lease them to Frank Lyon Company.

Q. What about the Family Clinic Building? A. Yes, we built the Family Clinic Building close to Town and Country Shopping Center.

Q. What kind of building is it? A. A building for four or five doctors occupy. We also built the ESSO service station later on.

Q. In each of these real estate investments prior to [401] time the permanent loan—in the first place, did you finance each of these buildings? A. Yes.

Q. Prior to the time the permanent loan was paid off, did the companies who owned the building get any return or did the stockholders get anything out of those companies? A. I heard Ralph Cotham testify yesterday that there was a nominal return. I didn't know there was any.

I'm one of the stockholders. I certainly haven't ever gotten anything out of it.

Q. What then was your purpose in investing in these buildings? A. To build up equity in them. We think it is a good way to acquire equity and build up equity.

Q. Mr. Cotham also mentioned as one of the purposes for going into further expansion and further investment was to avoid the accumulation of earnings tax on unreasonable accumulation of earnings. Was that one of the considerations? A. That was prior to the Worthen Building. We had been warned we had been accumulating earnings.

Q. Warned by whom? A. By the IRS, of the Internal Revenue Service.

Q. And that you better do what? A. Make use of the money.

Q. Mr. Cotham also mentioned that the purchase of the [402] Worthen Building might strengthen your relationship with Worthen. What weight did you give to that particular reason. A. I heard Mr. Cotham testify to that. I don't take any stock in that now and I didn't then. I don't know how it would strengthen it.

Q. Turning now, Mr. Lyon, to the real meat of this question. In entering into this transaction, what was the intention of Frank Lyon Company as to whether or not this was a good faith bona fide investment by Frank Lyon Company in the building or whether it was the Frank Lyon Company served the role as a strawman or accommodation to Worthen in putting together this package. A. I had never heard that before until the last few weeks. It never entered my mind. I am really shocked that anyone would take that approach to it. We certainly wouldn't get on a $7 million note by ourselves as an accommodation to anyone. We've got to carry that on our balance sheet for 25 years and I might add that our suppliers, RCA and Whirlpool, are very zealous about our balance sheets: who we owe, how much we owe and how liquid we are.

Q. In your view and intent, did Frank Lyon Company borrow the $7 million interim loan from First National City Bank? A. I don't think there can be any argument or mistake about that at all. I think New York Life thinks that. First [403] National City Bank thought that. I don't believe that they would enter—I heard it called a sham deal here yesterday by someone. I just can't imagine. In the first place, Worthen Bank wouldn't do such a thing and I've known them a long while. I would like to think we wouldn't do such a thing.

Q. What was your intent with reference to the New York Life loan for permanent financing? By "your", I mean Frank Lyon Company. A. That the corporation owes it and it either has to go broke or pay it.

Q. At the time these negotiations were entered into, Mr. Lyon, was there any understanding either written or oral between Frank Lyon Company and Worthen Bank that Worthen Bank would exercise its option to purchase at any time? A. Absolutely none. At that time I didn't think they could exercise it. I still hold that opinion. Of course they have the final say in that, not me.

We went into it on the basis they couldn't then. I don't think they could now. I don't know as much about it as they do, however.

Q. You are a member of the board, are you not? A. Yes. Yes.

Q. You are aware of the capital inadequacy of Worthen Bank, are you not? A. Yes.

[404] Q. Is this a constant subject of discussion in the board meetings? A. Yes. Ed Penick testified to that rather in detail yesterday and today. As rapidly as they are growing under the leadership they have I don't think that's going to stop any time in the foreseeable future. Like most aggressive banks, they are going to be in a capital bind.

Q. As a member of the Worthen board, do you think it would be economically wise for Worthen to pay at the end of 25 years, even forgetting the much higher prices in earlier years—do you think Worthen would be economically wise to spend $2,146,000.00 round figures on that particular building in view of the fact that they have an option to renew the lease for 40 years at these very favorable lease terms?

Mr. Sayre: I would like to object to that question being put to this particular witness because he is the person whose interest could be affected should the option be exercised, and his testimony naturally—he would have a hard time separating himself from—wearing both hats in this instance.

It does call for strictly an opinion on something which Mr. Penick testified is not going to occur for a long period of time and will have to be decided at that time.

The Court: I have kept an open record here. I am going to receive it subject to the objection.

You may answer.

[405] The Witness: I think they can make better use of their capital, particularly at the low rent at that time. He can certainly tell more about it.

By Mr. Williamson:

Q. One other line of questioning, Mr. Lyon. Has Frank Lyon Company been approached since you bought Worthen Building? Have you been approached by other investors over the possibility of wanting to buy the Worthen Bank Building from Frank Lyon Company? A. Yes, I guess we have been approached at least a dozen times. The last one I recall vividly and I was impressed with was a company by the name of Cabot, Cabot and Forbs. I believe they are from Boston. They came to Little Rock and then wrote us a letter.

Mr. Williamson: Your Honor, I would like to introduce in testimony as Plaintiff's Exhibit No. 51, a letter from Cabot, Cabot and Forbs Equity Trust dated April 26, 1974 addressed to Mr. Frank Lyon, chairman of the board of Frank Lyon Company.

The Court: Any objection?

Mr. Sayre: Your Honor, may I finish reading it here?

The Court: Very well.

Mr. Sayre: May I ask for what purpose it is being offered?

[406] Mr. Williamson: I am offering it as proof that this identical package is an attractive investment opportunity for investors.

Mr. Sayre: I have no objection for that purpose, Your Honor, because we already have two other investors.

The Court: It will be received as Plaintiff's Exhibit No. 51.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 51 and was received in evidence.)

Mr. Williamson: Since the exhibit speaks for itself, Your Honor, I shan't ask anymore questions on this.

The Court: Very good.

By Mr. Williamson:

Q. One final question. Mr. Lyon, there's been introduced into evidence a letter which you wrote to Mr. Penick dated April 12, 1962 which has been introduced into evidence as Plaintiff's Exhibit No. 50.

Would you give the Court your recollection of that particular transaction?

The Court: That's April 12, '68, is it not?

The Witness: '68, yes, Your Honor.

Mr. Williamson: Did I say '62? Sorry.

The Witness: Yes, I recall the letter.

[407] By Mr. Williamson:

Q. Do you remember what concerns were being expressed? Who talked to you about it? A. Ed Penick talked with me about this and asked for such a letter and I thought it was completely in order at the time and still do.

Q. And his concern at that time as expressed to you was what? A. That someone might purchase the building that would be embarrassing to them; that they would like to have an owner that was not someone they would be embarrassed by.

Q. I believe, though, that this is directed toward the problem of Frank Lyon Company, not the building, ownership of Frank Lyon Company passing to some outside—— A. Yes.

Q. —person. A. Yes.

Q. Is this what that letter was directed for? A. Yes, it covered both of those subjects.

Q. Did Mr. Penick express concern not only as to current—that this possibility happening not only during the first 25 years but thereafter, at which time he would have no option to purchase? A. I think this letter covers that, if I understand correctly, and if I remember it right.

[408] Q. This was a concern of his, was it? A. Yes, and a very valid one, sir.

Mr. Williamson: No further questions.

The Court: Mr. Sayre, you may cross examine.

Cross Examination

By Mr. Sayre:

Q. Mr. Lyon, you were talking about the other buildings that you built in realty corporations where you are build-

ing up equity. Those buildings, do they have options to repurchase by the lessee? A. No, sir.

Q. So in other words, once the amount is paid off the realty company would be the owner? A. That's correct.

Q. Now in this venture with Worthen Bank, if you're building up equity in the building and at the end of any of the option periods, the value of that property has appreciated. Worthen Bank could exercise its option price and take the ownership of the building away from you and take the appreciation away from Frank Lyon and enjoy that themselves; is that correct? A. They certainly could.

Q. Now with regard to this transaction, there is no pretax cash flow for Frank Lyon Company; is that correct? A. That's correct.

[409] Q. And you said you had looked into diversification and equity interest and tax consequences and you had explored the tax consequences and the possible use of the tax deductions attendant to this transaction for the purpose of applying this other income of Frank Lyon Company? Had you made such computation? A. Yes, such computations were made. We hadn't looked into where we could use the money. We didn't know at that time.

Q. And the tax consequences—since there was no pretax cash flow, the post-tax cash flow created by the accelerated depreciation was an important factor in this deal. A. It was a factor.

Q. Now you said that with regard to Frank Lyon Company being a straw man or a conduit from both the First National City Bank loan and the New York Life loan, the agreement between you and Worthen Bank made it such that if Worthen Bank could not produce or finish the building as scheduled for any reason, they would agree to buy the building back from you plus a ten percent factor. So there was no risk to Frank Lyon Company with regard to that unless Worthen Bank went under; is that correct? A. I didn't recall that particular part of it. Ralph Cotham may have testified to that. I don't know.

[410] Q. With regard to permanent financing with regard to New York Life, everything was assigned to New York Life. By that I mean your rights under the lease, under the ground lease. A. Yes, sir. Yes, sir.

Q. Everything Worthen had in the garage. A. Yes, sir.

Q. Everything went to New York Life. A. Yes, sir, they will get everything they can. Q. Under this assignment or under the lease, there is nothing that will reduce the amount of rental that Worthen Bank is obligated to pay. If the building is damaged or if you owe Worthen Bank an amount of money, it can't be set off against it. In other words, there is an absolute obligation on the part of Worthen Bank to pay this amount of rent quarterly: is that correct? A. There is an absolute obligation on us to pay it also.

Q. Now you have assigned your rights under that lease to New York Life, and if you said you were alone on the note, if you do not make your payments, that the assignee, New York Life, has the right to collect the rentals directly from Worthen Bank; is that correct? A. I'm sure they do.

Q. And they are equal to the debt service that you [411] would owe; is that correct? A. I'm sure it is.

Q. Now with regard to Plaintiff's Exhibits 13 and 14, if we may have those, please.

Those are the specifications sheet of Worthen Bank as to what the package they would offer and the next one is your acceptance on behalf of Frank Lyon Company. Now on the first paragraph that's numbered, it says that equity of $500,000.00 would have to be put up for the interest rate to be paid at an interest rate of six percent. You have been in the courtroom during this time and it's been testified to that that six percent represents a return on the $500,000.00 if and when the option is exercised. Is that the way that that provision was understood by you or by Worthen Bank or at least by you at the time it was entered into? A. Ask me that question again. Re-state the question.

Q. The $500,000.00 provision at six percent interest, was it your understanding when you entered into this negotiation that that amount would represent or be represented by the option price, the amount to be realized by the option price? A. No, sir. At least that wasn't my understanding.

Q. What is the rate of six percent interest as stated on Plaintiff's Exhibit 13? What did that mean to you? A. Well, it just didn't have any meaning to me until [412] I got in here. I didn't remember about the six percent at all. I recall very distinctly we had to put up a half a million dollars in equity capital. I had forgotten about the six percent, if I ever knew it.

Q. Do you recall why when you responded to that provision that on the second page of Worthen's specifications they show the option price at 15 years, and when you replied you responded at 11 years. Do you recall why that—— A. No, sir, I do not. Their specifications is 15 years and we cut it to 11?

Q. It's re-stated as 11 on your acknowledgement. A. Their specifications were 15 and ours were 11?

Q. Referring to number six, which was the prepurchase at the 15th year and you responded and made a calculation of 11 years. Do you recall why the difference? A. No, sir, unless we were trying to make it more attractive to them so we would get the opportunity to own the building.

Q. The computations that you made or had made by Mr. Cotham show that the maximum tax benefit on the tax shelter would occur after 11 years; is that correct? A. I heard that yesterday.

Q. Now since this is a net lease and since Worthen Bank said they wanted this to be their building for their control of it, Frank Lyon Company assumes none of the risks of [413] operation of that building; is that correct? A. Correct.

Q. And with regard to the loan, Worthen Bank pledged land under the buildings and parking garage as additional security for the loan that was made ostensibly to you or to

Frank Lyon Company; is that correct? A. Correct. That is quite common. It also happened in Springfield.

Mr. Sayre: No further questions, Your Honor.

REDIRECT EXAMINATION

By Mr. Williamson:

Q. If Worthen Bank went broke, Mr. Lyon, would you be liable on your New York Life loan? A. Yes, sir, we would. If I understand correctly, we would.

Q. Were you in the courtroom this morning which it was brought out even if Worthen exercises its options to purchase at the end of the 11th or 15th year, that Frank Lyon Company is still liable on the note throughout the life of the loan? A. Yes, sir, I was here and heard that this morning.

Q. Did it come as some surprise to you? A. Yes, sir. It may not have to Ralph Cotham. I believe it came as a surprise to me and C. W. Abrams. I didn't [414] ask him yet. I didn't want to tell him right now.

Mr. Williamson: No further questions.

The Court: Let me ask you this: I want to ask who initiated the matter as between you and Worthen?

The Witness: I did, Your Honor.

The Court: Do I understand that rather late in the day you became aware of this situation?

The Witness: Yes, sir.

The Court: Latter part of October?

The Witness: Yes, sir.

The Court: At a time when the company was pretty far down the line in dealing with Goldman Sachs and the Stephens group and so forth?

The Witness: Correct. Yes, sir.

The Court: No one from Worthen came to you and said, "Why don't you put in a proposal?" Is that correct?

The Witness: No, sir, they sure didn't. In fact, I didn't feel like we were very welcome at that late date.

The Court: And you were not privy to discussions or associations with other people?

The Witness: No, sir, I have found out more about it in here. I'd like to know what it was.

The Court: You mean during the course of the trial you found out you probably left maybe $125,000.00 on the table?

[415] The Witness: Yes, sir. I got that feeling that we did.

The Court: All right. No other questions.

Mr. Williamson: No further questions.

Your Honor, the plaintiff rests.

Mr. Sayre: I would like to call very quickly Mr. Richardson to the stand, please, sir.

The Court: Come around, please, sir, raise your right hand and be sworn.

Thereupon,

Charles Richardson

having been called as a witness by and on behalf of defendant, and having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

By Mr. Sayre:

Q. Would you state your name and address, please, sir?
A. Charles Richardson, Number 9 Pyeatte Circle.

Q. What is your employment or profession? A. Internal Revenue Agent.

Q. Were you the agent that audited the Frank Lyon Company for the year in suit? A. That's right.

Q. You have been in the courtroom throughout this trial. May I ask if you are familiar with the transaction we [416] are speaking of? A. Yes, sir.

Q. At my request have you made certain computations reflecting certain tax benefits of Frank Lyon Company? A. Yes, sir.

Q. Specifically, I refer to Defendant's Exhibit No. 2 which is before you.

The Court: Is there an extra copy of that?

Mr. Sayre: There is one on the stipulation, Your Honor.

By Mr. Sayre:

Q. May I ask if that—what that exhibit shows as far as the pretax cash flow of the corporation to be? A. It shows a zero balance of cash flow in and out.

Q. Through the period of the first 11 years of the—— A. Lease.

Q. —the lease. And the—excuse me. After 11 years is the date the first option is exercisable; is that correct? A. Yes, sir.

Q. The figures on the bottom of the page show some computations at 25 percent and others at 48 percent. May I ask you to tell the Court what that figures of $649,756.00 represents? A. Well, that would be—this computation actually [417] is prior to the Revenue Act of 1969. It would change what the computation would be but this is made on the basis of the law prior to that. It would be the actual cash benefit that would flow to Lyon Company from this transaction if the options were exercised in 1980.

The Court: At the first opportunity.

The Witness: Yes, sir.

The Court: How can the Frank Lyon Company get its money back from Worthen, the borrower?

The Witness: By Worthen exercising the option.

The Court: In other words, there is no way legally he can get it back. It takes Worthen to make a decision for it to get any money back.

The Witness: To the best of my knowledge.

The Court: And it's the same thing in terms of making any income in terms of what you call interest. It takes a decision by Worthen to exercise the option.

The Witness: Right.

The Court: On the other hand, if they do not exercise those options, then what happens to your analysis in terms of the loan?

The Witness: You mean if at no time Worthen exercises the option? If Frank Lyon continues to be the owner of the building, per se? It wouldn't be right. It wouldn't be valid.

By Mr. Giroir:

Q. If Worthen never exercises the option and it's been accruing this six percent every year and at the end of 25 years [437] accrued two million plus dollars of income and paid taxes on it and then the option lapses, does Frank Lyon get a deduction for that $2 million? A. Which $2 million have you got in mind?

Q. The six percent you have been accumulating over 25 years. A. You mean——

Q. The income of $2 million that you have been accruing that all of a sudden they don't have the right to receive. What do they do with it? What do your regulations and guidelines tell them to do? A. They could file a claim. Wait a minute.

Q. Isn't it barred for every year past three years? And if they file a claim do they get it back with interest? A.

No. Wouldn't you mitigate Section 13.712? I'm not sure whether it would be effective or not.

Q. Doesn't it illustrate the ridiculousness of your accrual? A. No.

Q. Let me ask you one question. One of your factors was the down payment and the return of the down payment. Did you discover any evidence that indicated that Frank Lyon had a legal, written or unwritten, express or implied right to demand repayment of that 500, plus interest? A. No. Nothing written that I saw.

Q. Let me ask one other question now that has to do with [438] interim interest.

Did you observe the interim interest was, in fact, paid by the Frank Lyon Company? That is the interest during this period to First National City Bank, that $400,000.00. A. Yes, $456,000.00, right.

Q. Did you see the canceled checks? Did you see that they did pay it? A. I don't believe I looked at the canceled checks. I ordinarily wouldn't have.

Q. You heard testimony it was paid by the Frank Lyon Company? A. Right.

Q. Did you see anything that would have contradicted that testimony? A. I looked at the general ledger that satisfied me.

Q. That did satisfy you that Frank Lyon did pay it? A. Right.

Q. And yet you disallowed the deduction for that payment? A. Right.

Q. Did you also see the $7 million note that the Frank Lyon Company executed to First National City Bank? A. Did I see the note itself?

Q. Did you see evidence of the note? A. I saw evidence of the note. I'm not sure whether [439] I looked at the note itself or not, but I saw evidence to satisfy myself that——

Q. Under your instructions, if they, in fact, borrowed the money and, in fact, owed it and, in fact, paid interest

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS

May 16, 1975

Mr. J. Gaston Williamson
720 West Third Street
Little Rock, Arkansas 72201

Mr. Eugene G. Sayre
Department of Justice
1100 Commerce Street
Dallas, Texas 75202

Mr. W. H. Dillahunty
United States Attorney
P.O. Box 1229
Little Rock, Arkansas 72203

Re: Frank Lyon Company v. United States of America
No. LR-73-C-247

Gentlemen:

Circumstances will not permit the Court to file an elaborate memorandum supplementing the findings and conclusions that it made in open court at the conclusion of the trial. Nor is an elaborate memorandum necessary in this case.

There are no true factual issues remaining, and the parties are in general agreement as to the applicable law. They do disagree with respect to the inferences to be properly drawn from the evidence and have different opinions as to the application of the legal principals involved.

The Government contends that although the "form" of the transaction was a sale and leaseback arrangement, the "substance" amounted to a nonrecourse loan for federal tax purposes. The plaintiff, on the contrary, asserts that the transaction, for federal tax purposes, was in "sub-

stance" exactly what it was in "form, that is, a sale-leaseback.

After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws.

The defendant concedes that Worthen turned to the sale-leaseback arrangement because of the net capital requirements of the Federal Reserve Board. See footnote, page 1, Defendants Supplemental Memorandum of Fact and Law, filed December 20, 1974. It is likewise clear from the evidence that Worthen was going with such an arrangement, one way or the other, before the plaintiff entered the picture.[1]

The theory of the defendant that the plaintiff "loaned" Worthen $500,000 is completely untenable, both in fact and law, as indicated by the Court at the conclusion of the trial. As there stated, it is most unlikely that Worthen will exercise the option at the end of eleven years, or, indeed,

[1] The Court senses that a controversy might not have arisen at all had Worthen concluded the same, identical, transaction with parties other than the plaintiff. The close relationship between the plaintiff and Worthen appears to have made a great impression upon Mr. Charles Richardson, the agent who wrote the report which started this case on its way to this Court.

arising out of lessee's use of the premises and to pay rent during the initial term in an amount sufficient to amortize the mortgage on the building are all terms which are quite common in long-term real estate leases. Such assumption by Worthen of the risks of operation normally borne by an owner did not make Worthen the owner of the building for tax purposes.

9. All of the other terms of the agreements among the parties and the surrounding circumstances which defendant contends are collectively sufficient to make Worthen the owner of the building for tax purposes are common in and consistent with a bona fide sale-leaseback with option to purchase, and do not, individually or collectively, make Worthen the owner of the building for tax purposes.

APPROVED AS TO FORM:

/s/ J. GASTON WILLIAMSON
J. Gaston Williamson
720 West Third Street
Little Rock, Arkansas 72201
Attorney for Plaintiff
W. H. DILLAHUNTY
United States Attorney

By /s/ EUGENE G. SAYRE
Eugene G. Sayre
Attorney for Defendant

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Judgment

(Filed June 11, 1975)

Findings of fact and conclusions of law having been entered in the above-styled case, judgment in conformity thereto is hereby entered in favor of plaintiff in the following amounts with interest thereon from the dates indicated:

$32,624.32 with interest thereon from March 15, 1969;
$231,871.26 with interest thereon from March 15, 1970;
$43,790.84 with interest thereon from April 19, 1973.

DATED this 11 day of June, 1975.

/s/ GARNETT THOMAS EISELE
District Judge

By Mr. Sayre:

Q. Now——

The Court: In other words, you are saying the known tax benefit in effect would be zero and the tax based—and I mean the cash flow resulting from the depreciation.

The Witness: It's really a two part. The first part, the $3,458,174.85 would be the capital gain which Frank Lyon would realize—Frank Lyon Company would realize in 1980. That would be taxed at 25 percent.

The Court: Upon the exercise of that option.

The Witness: So they would have that much tax liability at that time. The tax they would save would be the savings from the rental loss.

By Mr. Sayre:

Q. The rental loss is the $3,154,000.00? A. Eight hundred nineteen and eleven cents. It's at 48 percent.

Q. So the tax savings in tax dollars through that 11 [418] years would be the six hundred forty-nine thousand? A. That's right.

Q. That would be in tax dollars that had been saved up to that period? A. That's right.

Q. That doesn't include the actual cash realized upon the sale? A. No. No. That is tax dollars saved.

Q. Exhibit No. 3, would you identify that to the Court, please? A. Exhibit No. 3 is a computation of the rental operation for this 11 year period that we are referring to through November 30, 1980 and it would show the net rental loss that we referred to on the prior exhibit.

Q. And the net rental loss over that period of time would be how much—and the net loss to Frank Lyon attributable to these rentals—that being the interest and depreciation—would be how much? A. Three million one hundred fifty-four thousand eight hundred nineteen and forty-four cents.

Q. No. 4 is what, please? A. No. 4 is a computation of what the gain would be to Frank Lyon Company if the option were exercised in 1980. That's the sale price over the adjusted basis to Frank Lyon Company at that date. [419] Q. That being taken on the double declining balance method? A. Right.

Q. That is the figure that was plugged in on Exhibit No. 2? A. Yes. Yeah.

Q. Now Exhibit No. 5. Will you identify that for the Court, please? A. Actually, Exhibit 5, the applicable part here really is economic gain, which is shown in the bottom half of that exhibit, and the economic gain would be the gain on the sale of the building back to Worthen less the rental loss, disregarding taxes.

Q. When you say "the economic gain", we are referring to the amount of actual cash realized by Frank Lyon over and above the original $500,000.00 investment? A. Yeah. Yes, sir.

Q. And does this correspond then to what Mr. Cotham testified to as the approximate $800,000.00 figure? A. Yes. I don't have them in front of me, but the adjustment as set up in my RAR reflects it that way. Revenue Agent's Report.

Q. Would you reflect it as an $800,000.00 gain with a $500,000.00 return of equity and a $303,355.74 return of profit? [420] A. Right.

Q. Now if you take the actual cash amount realized, which has been testified to be the six percent figure, the three hundred thousand, would that be added to the $649,769.46 in tax dollar savings? A. That's right.

Q. So there would be an economic benefit under the pre-1969 law of approximately $950,000.00? A. Yes, sir.

Q. If the option is exercised after the end of 11 years; is that correct? A. That's right. That's right.

Q. Defendant's Exhibit No. 6. Can you identify that for the Court, please? A. It's a similar computation with the option being exercised after 11 years taking into account

the changes in the tax law as it would affect this type transaction by the Revenue Act of 1969.

Q. What is the major change that affects this, please? A. It would——

Q. Excuse me. The basic change in the revenue law, the Act of '69 would have affected this transaction? A. Part of the gain would be recognized on a sale in 1980. Part of the gain would be recognized as ordinary income rather than as a capital gain. They changed the rates.

[421] The Court: I need to see No. 6.

By Mr. Sayre:

Q. You said part of the gain would be realized as ordinary income rather than capital gain? A. That's right.

Q. What part is that? A. What's the dollar amount of that? Is that what you mean?

Q. What I'm saying—— A. How do you arrive at that?

Q. —what is it attributable to? A. It is the excess of the accelerated depreciation over straight line depreciation over the 11 year period.

Q. Has that been calculated on this exhibit? A. Yes.

Q. Now the direct benefit is the cash benefit received or cash money received at the exercise of the option, the three hundred three thousand three fifty-five seventy four. That would not have changed? A. That still would be the same.

Q. What is the tax savings or tax dollar benefit? How was that computed? A. Well, it would be the rent loss—the savings would be the tax on the rent loss as it was computed originally on the original computation. That amount is 48 percent of [422] of $3,154,819.00 or $1,514,313.17.

Then in 1980 the taxpayer would have to recognize the part of the gain which is considered Section 1250 gain as ordinary income.

Q. Excuse me. That is the accelerated depreciation has to be recaptured? A. Yes. That is the excess. Right. And

that is $914,668.15. And the tax on that which the taxpayer would have to pay would be $439,040.71. Then the balance of the gain would be capital gain, and the rate at present on a capital gain would be 30 percent of it.

Q. What would be the balance? Is that shown on the last line? A. Yes. $2,543,506.70.

Q. And what would the tax on that be? A. $763,052.01. So that would be a tax that the taxpayer would incur also in 1980 if he exercised the option.

So the net gain in taxes would be the difference between the tax savings on the rental loss less the 1250 tax and the 1231 tax, so it would be a net tax savings of $312,220.45.

This is over the period of the 11 years of the transaction; is that correct? A. Right.

Q. And then what would the total of that tax savings [423] and the direct cash received on the sale and the gain be? A. The total savings would be $615,576.19.

Q. That is as opposed to the total of $649,303.00 or some $950,000.00 under the pre-'69 law? A. Yes, sir.

The Court: Which law will apply?

Mr. Sayre: The post '69 law, Your Honor. We prepare these to show both the computation at the time the transaction was entered into and as of present date.

The Court: Of course, the law could change again.

Mr. Sayre: The law could change again.

I have no further questions, Your Honor.

The Court: Any questions of this witness?

Mr. Giroir: Yes, Your Honor.

The Court: In other words, just roughly, the benefit to the taxpayer under the prior law, about two-thirds of his benefits were as a result of the tax laws and about one-third, more or less, the economic benefit?

The Witness: Yes, sir.

The Court: And under the present law about half and half?

The Witness: Yes, sir.

CROSS EXAMINATION

By Mr. Giroir:

Q. Mr. Richardson, how long have you been with the [424] Internal Revenue Service? A. 1956.

Q. In what capacity? A. Internal Revenue Agent.

Q. You have been an agent during that entire time? A. Afraid I have.

Q. What is your educational background? A. I have a B.S. degree from the University of Arkansas in accounting.

Q. Any other degrees? A. No.

Q. Have you had any formal training in taxes? A. Within the Internal Revenue Service we have, yes.

Q. What type of program do you have? A. A basic revenue agent school and I have attended that.

Q. When did you attend that? A. 1956.

Q. Have you attended any school since that time? A. Advanced schools since then and then we have more or less workshop or annual institutes that we attend a week or a few days sometimes.

Q. A week or a few days? A. It will be a week or two or three days sometimes.

Q. How often does that occur? [425] A. Annually.

Q. Are those general type seminars? A. Primarily just tax changes.

Q. Have any of them been on real estate transactions? A. Not specifically.

Q. Have you ever done any specific study on real estate transactions? A. Just when as a revenue agent I had a problem that dealt with real estate.

Q. I assume that problem would only come up if you were examining someone who had a real estate investment; is that correct? A. Or sold real estate.

Q. Who had an investment or either operated it or sold it? A. Right.

Q. But you are—or are you familiar with the laws and the regulations and the rulings dealing with depreciation? A. To some extent at least I am.

Q. You seem to be qualifying. Are you or are you not familiar with the laws. A. Specifically what do you have reference to?

Q. The ones that are in issue here in this case. A. I think I am. I certainly hope so.

Q. And also with respect to the capital gains on sale [426] of a capital asset, are you familiar with those rules and regulations? A. I think so, yes, sir.

Q. And as to the deductibility of interest—— A. Yes.

Q. —are you familiar with those rules and regulations? A. Yes.

Q. Have you ever examined any other corporation that is of similar size to the Frank Lyon Company? A. Yes.

Q. How many? A. How many?

Q. Yes. A. Gosh, I don't know; four or five a year maybe for the last seven or eight years.

Q. So four or five times a year for the last seven or eight years you have encountered tax returns involving corporations of at least the same size in terms of assets and revenues as Frank Lyon Company? A. Yes.

Q. And with problems as complex as those you found in Frank Lyon's tax return? A. I would think so, yes, sir.

Q. How many corporations do you examine regularly who have or which have real estate investments? [427] A. Ordinarily, not of this type. I have had a similar problem but not quite like this.

Q. How many have you examined that have real estate investments? Can you tell me how many corporations' returns? A. It would just be a guess.

Q. Could you guess? A. Four, six.

Q. Four or six over the last 25 years? A. No.

Q. Four or six a year? A. No. Four or six over the last seven or eight years. We are talking about this size corporation.

Q. I am thinking now any corporations that have similar type real estate investments. A. I don't know of many corporations in Arkansas that have similar type real estate investments. Personally, don't.

Q. But in any event, you have not examined any that have similar type real estate investments? A. Exactly like this, no.

Q. Have you examined many that own real estate as an investment? A. Yes.

Q. How many? A. I'd say four or five.

Q. Over your 25 years? [428] No, over the last seven or eight years.

Q. Four or five corporations that have real estate investments?

The Court: Let me ask so I can understand why you are pursuing this. Do you disagree with the analyses which have been made by this witness and reflected in the exhibits introduced or referred to?

Mr. Giroir: Your Honor, this agent prepared an RAR, which proposed a deficiency in the tax paid by the Frank Lyon Company. One of his findings was, and I quote, "It has been determined based upon the facts and circumstances that you, Frank Lyon Company, are not the owner for tax purposes or any portion of the Worthen Building."

The Court: Well, that really is beyond the scope of cross examination, but you are about to take him into new matters. I didn't know whether you are going into his qualifications on the ground you were disagreeing with these matters or, as I now see, you want to turn to a new matter.

All right.

Mr. Giroir: While I have mentioned it, let me introduce into evidence—I'm sorry I don't have copies—but one page from the RAR that deals with this problem. It's page six of the RAR for the years 1969 and 1970.

I'd like to ask the Court to be able to reproduce it and furnish it formally. I believe Mr. Sayre has seen it.

[429] The Court: That was prepared by the witness?

The Witness: Yes.

The Court: Hand it to him and ask him if it is so.

The Witness: That's right.

The Court: All right. It will be Plaintiff's Exhibit 52. Any objection?

Mr. Sayre: No, Your Honor.

The Court: It is received without objection.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 52 and was received in evidence.)

Mr. Giroir: I won't need it for reference, Your Honor.

The Court: Then I will look at it.

All right.

By Mr. Giroir:

Q. Now as to real estate investments, generally, are you familiar with the laws dealing with accelerated depreciation versus straight line depreciation, which were in effect in 1967, '68? A. Right.

Q. Would you explain exactly what accelerated depreciation is? A. Well, it's double declining and some of the year's [430] digits are—that's primarily accelerated depreciation which allows the taxpayer to claim more, an amount greater than straight line in the earlier years of the life of the assets.

Q. And what happens during the subsequent years? A. It tapers off and gets lesser as the asset ages.

Q. Do you know the theory behind or the reason for the allowance of accelerated depreciation? A. Well, I think I do. I'm not sure that I know.

Q. Would you state your best understanding of it? A. My understanding is that it allows the taxpayer to recover cost in the earlier life of the asset as he's expending paying for the asset in the earlier part and also for immediate obsolescence of assets and expenses of that nature.

Q. When you say "to encourage investment", are you saying that the code—— A. Well, I don't—did I say encourage investment?

Q. I think you did. A. I think that is a factor but I didn't know that I said that.

Q. Is this an approved form? A. Oh, yes. Yes.

Q. And is there anything illegal or immoral or improper about taxpayer utilizing accelerated depreciation? A. No, sir.

[431] Q. Does it become illegal or immoral or improper if you buy an asset intending to use accelerated methods? A. No.

Q. As to capital gains, what rate is applicable to capital gains for corporations? What rate of tax? A. When?

Q. On a long-term capital gain. A. When? What year are we talking about? It changes with the Revenue Act of '69. It went from 25 to 28, 28.7.

Q. Well, state for both periods then. A. Well, for long-term?

Q. Yes. A. Well, the Revenue Act of 1969 changed it from—it had been 25 percent for a corporation for—since Revenue Act of 1954, Internal Revenue Code of 1954. Then '69 Revenue Act changed it starting, I believe in '70 for 28.7 or——

Q. Roughly 25 to 28 percent? A. Then it went to 30 percent.

Q. Twenty-five to thirty is the effective rate on capital gains for corporations? A. Right.

Q. How is depreciation classified as an expense? Is that ordinary expense or a capital expense? A. Ordinary.

Q. And that is reduces tax to a corporation such as [432] Frank Lyon—— A. Correct.

Q. ——which is at the maximum bracket, at what rate? A. Whatever their tax bracket is.

Q. What is the maximum bracket? A. Forty-eight percent.

Q. So to Frank Lyon it reduces their taxes by what percent? A. Forty-eight percent.

Q. Now 30 to 48 percent is what percent difference? Eighteen? A. Yeah, percent. Okay.

Q. If an asset is depreciated and you receive an ordinary deduction and then it's sold at a price in excess of its cost basis, depreciated cost, then you pay tax on the gain at what rate? A. Capital gain rate.

Q. And we'll say for Frank Lyon what percent? A. Between 25 and 30. You know, it just depends on which year. In 1980 you would say it would be based on the law right now—it would be 30 percent.

Q. So he could have got a deduction at 48 percent and paid tax at 30 percent and received an 18 percent benefit? A. Right.

Q. Is that legal? [433] A. Yes, sir.

Q. Is anything wrong with doing that? A. No.

Q. It is sanctioned by the law and the code? A. Right.

Q. Does it become wrong if you buy a capital asset intending to take advantage of this difference between the rates? A. Does it——

Q. Does it become illegal if I buy a piece of property intending to depreciate it at 48 percent and sell it and pay tax at 30 percent and pocket the 18 percent difference?

Is there anything illegal about that? A. Not to my knowledge.

Q. Is it illegal if I intend to do it when I buy this asset?

The Court: We don't need to ask this witness what is legal and illegal. What I would like to find out is an answer to this question: In your explanation here you say: "It has been determined based on the facts and circumstances that you are not the owner for tax purposes of any portion of the Worthen Building."

Would you tell the Court what the facts and circumstances were upon which you predicated that statement?

The Witness: Well, it was my determination at the [434] time that, as a revenue agent, in my opinion Frank Lyon Company didn't own the building, as such. If they didn't own the building——

The Court: You based that upon facts and circumstances, you say. What were the facts and circumstances that made you conclude they did not own the building? They had the title and it was on record down there in the courthouse.

The Witness: They had the bare legal title. The Worthen Bank assumed all the risk of ownership, they paid the taxes, they——

The Court: On the land, you mean.

The Witness: They paid taxes, insurance, and all other expenses.

Could I refer to my report?

The Court: Certainly.

The Witness: Another factor would be that part of the assets owned by Worthen were used as security for the loan, indicating to my way of thinking that it was their asset.

And the option to repurchase would be another indicating maybe—you know, in favor of saying, to my way of thinking, that Worthen owned the building.

Conduit of the pass on the rental payment. The ground lease being a nominal amount. The risk of ownership. I previously mentioned that. Again, the down payment and [435] the return, which is practically equivalent to the interest factor which has been previously discussed. Those were primarily my reasons.

The Court: Let's see if we can deal with that and maybe find out the more critical ones. Is there anything unusual in a lease arrangement between the landlord and the tenant for the obligation—for the lease agreement to provide that the tenant will pay the taxes and the insurance?

The Witness: Well, it's just one of the group of factors, the way I look at it. It, in itself—if none of the other factors had been present, I would say no.

The Court: Is there anything unusual with the tenant in the lease having to repair and maintain the building?

The Witness: Not in itself.

The Court: Now have you had experience with many of these sale and leaseback arrangements?

The Witness: No. I'm finding many more people that are expert than I am in this courtroom.

The Court: Do you have instructions from the department which tell you what to look for and what makes a transaction, in effect, a ruse: not what the papers say it is, but, in fact, something else?

The Witness: Basically, I try to research the issue since it is facts and circumstances what really make the [436] decision. Substance versus form. In its form I have no question in my mind.

The Court: You have treated this as a loan of $500,000.00?

The Witness: Correct.

on it, weren't they entitled to a deduction? A. Ordinarily I'd say yes, but——

Q. What distinguishes this situation? A. As I told the Judge, that the evidence to me indicated that Worthen owned the building, that Frank Lyon Company was not really the beneficial owner of the building.

Q. Even in Frank Lyon Company was lending $7,640,000.00 to Worthen for Worthen to construct its own building and if Frank Lyon Company had to borrow seven million of it and pay interest on that borrowing, weren't they entitled to a deduction? A. Well, under the way I see it is that they did not own the building and as long as they didn't own the building they wouldn't be entitled to the deduction.

Q. Even if they in the wildest stretch of your imagination did what you said they did and bought it on a pure financing arrangement and leased it on a financing arrangement in your terms to Worthen, if they had to borrow the money to buy the asset to lease it, weren't they entitled to an interest deduction on what they borrowed? A. If they have no assets——

[440] Q. But they've got a $7 million obligation on which they had to pay interest. Now did you consider in your research recent revenue ruling 72543, which involved a leasing situation, a pure leasing situation where the leasing company had to borrow money to buy the assets to lease, which the government treated as a financing arrangement? In that instance the government ruled that the leasing company, even acknowledging some viability to your organization, that the leasing company was entitled to an interest deduction and to a deduction for attorneys expenses involved in acquiring the assets they are leasing. I assume you are bound by the revenue rulings? A. Yes.

Q. Did you consider that? A. I sure didn't. I don't remember if at the time I did or not. I can't tell you. I could look at my research and tell you if you would like for me to do that.

Q. You have assumed that the option will be exercised, have you not? That the option Worthen Bank has to buy the building will be exercised? A. I made a computation to that effect.

Q. You haven't assumed it will? A. Made a computation to that.

Q. In your revenue agent's report, did you assume that the option would be exercised? [441] A. No.

Q. Did not assume it would be exercised—— A. I don't——

Q. —at the 11th year? A. I'm not following your question.

Q. You have testified to the Judge that the only way that you know of that Frank Lyon Company is going to be "repaid its down payment plus interest" is through the exercise of the option.

Now if that's the only way that Frank Lyon Company is going to be repaid, I have got to think that you assumed that the option was going to be exercised.

I will repeat: Did you assume the option was going to be exercised? A. I don't think I'm following you. I don't see how I can say that I assumed that. What I meant to say was at the time I wrote my report I determined that Frank Lyon was not the owner of the building.

Q. Would your report have been the same had there been no option? A. Well, I don't know how to answer that right now since it was there. I can't say for sure.

Q. If you had known all the facts that you know now and the option was there but you were told by Frank Lyon and confirmed by Ed Penick that was legally impossible for the [442] option to have been exercised, would your report have been the same? A. I'd have to study it some more.

Q. In other words, the likelihood of the exercise of the option at any date was not of material importance to you in writing your report? A. It was a factor. I sure was.

Q. But not a major factor? A. Well, it was—I couldn't say it was the major factor but I'd say it was a factor. I couldn't tell you how much weight right now.

Q. Well, let me ask you one final question: If, in fact, Worthen Bank was a lessee of the building Frank Lyon was the owner of the building, would all of the related adjustments which you made in your RAR be incorrect? All of them related to the building? A. If now——

Q. If you assume there was substance to Frank Lyon's ownership of the building? A. All right.

Q. —and if you assume it was truly leased to Worthen Bank and that the ownership of the building was in Frank Lyon and all the economic risks and gain were in Frank Lyon, that Lyon borrowed money from First National City, Lyon borrowed money from New York Life, owns the building subject to a lease, [443] then if that was your determination, would all of your adjustments as they relate to the building be wrong? A. Yes.

The Court: Certainly.

By Mr. Giroir:

Q. One final question. How can you impute interest if you don't assume the exercise of the option? A. Well, I don't think I put it that way in my report. Could I look at that page just a second there?

Q. Yes. A. I think in my—well, following this through, it would be the equivalent of the interest. This $500,000.00 that Lyon Company had loaned would be——

Q. You would have predicated it on a theory of a loan: a loan from Lyon Company to Worthen Bank? A. Rather than as——

Q. Let's stay to the $500,000.00. You would have assumed that Frank Lyon loaned Worthen $500,000.00; is that correct? Is that the basis on which you imputed interest? A. That would be the basis, right.

Q. Now when there is a loan there must be a repayment or else it is not a loan; it's a gift. Is that correct? A. That's right.

Q. When, under your theory, was the payment to occur? A. Well, under this theory, under the government's theory, since Worthen owned it all, the contract was——

Q. I'm sorry. I missed that answer. [444] A. It would be—under the government's theory, Worthen actually owned the building and all Frank Lyon would get out of it would be a return on his investment of $500,000.00—return on his loan of $500,000.00.

Mr. Sayre: Excuse me, Your Honor. We are belaboring this. We have agreed that the interest factor would come in only when the option was exercised. We will stipulate to that.

Mr. Giroir: What's bothering me is that the agent who wrote the report assumed a loan and a repayment and he's now unable to explain how it is going to be repaid. That's my question.

Mr. Sayre: We will be glad to stipulate we assumed the exercise of the option to create the interest factor of six percent.

Mr. Giroir: Your witness who wrote this report is not stating that was in his mind, and that's what I'm trying to ask.

Mr. Sayre: As far as that goes, the acts of the agent do not bind the commissioner and as far as the government is concerned in the matter we would agree that the assumption was made that the option would be exercised to come up with the interest factor.

To belabor the point, whatever Mr. Richardson's attitude is on it at the present time is not material.

[445] Mr. Giroir: Mr. Richardson's analysis of the entire transaction is what precipitated this lengthy and ex-

pensive trial. I think we are entitled to have his analyisis of how he got from there to here.

The Court: I think we are almost gettting down to the point of just arguing. He stated how he arrived at the idea that it was a loan and how he understood it would be—the interest so-called—would be paid.

The Witness: I think I misunderstood you, too. It would be on that same basis as I have written there, based on 11 year period, payable—then.

By Mr. Giroir:

Q. What is the 11 year period? A. The time period when the option—when Worthen's option would come up to repurchase.

Q. So you assumed that would be an exercise at the end of 11 years? A. Yes.

Q. Why did you pick 11 rather than 15 or 20 or 25? A. That was the first option period.

Q. Why did you make the assumption at all? A. Well, that was the first option period and that was the logical period for it to be exercised.

Q. Why did you make the assumption that it would be [446] exercised. On what basis did you make it? A. On the basis that it was a loan.

Q. Can you allow interest as an expense or require the recognition of interest as a gain if the likelihood of realizing that interest is uncertain? A. If the likelihood is uncertain?

Q. If there is no certainty that it will be paid. A. If there is no certainty that it will repay, I wouldn't think so, no.

REDIRECT EXAMINATION

By Mr. Sayre:

Q. Mr. Richardson, with regard to the issue of whether or not the party to this transaction who would bear the

economic loss or who would bear the economic burden of the wear and tear on the building, it was your testimony that—or your determination it was Worthen Bank rather than the Frank Lyon Company; is that correct? A. Yes, sir.

Q. In the substance of the transaction between these two, instead of the form; is that correct? A. Yes, sir.

Q. You disregard the form of the transaction? A. That's right, disregard the form.

Q. Was it your testimony that the some eight or ten factors that you considered at the time, that no one of those [447] factors was the key determining factor, but all of them taken together? A. All of them taken together, yes, sir.

Mr. Sayre: No further questions.

The Court: You may stand down.

(Witness excused.)

The Court: All right, Mr. Sayre.

Mr. Sayre: Your Honor, the government will close except for cross examination of the taxpayer's witness.

The Court: Anything else?

Mr. Williamson: Nothing further from the plaintiff.

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[3] PROCEEDINGS

[Filed June 3, 1975]

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The Court: What is your preference, gentlemen? This case turned out to be very much as I anticipated when we walked into the courtroom yesterday morning. Having heard the parties at pretrial conference and having read

the pretrial memoranda, it was obvious there really were very few, if any, issues of fact, although there were questions as to the inferences that could be drawn.

I think the Court has benefited very much from the testimony. I don't mean the trial wasn't helpful or necessary; I simply mean as it turns out there were, as anticipated by everyone, very few factual issues. The trial has been used as a vehicle to educate the Court and for the parties to argue their position, for which I thank you.

Now what do you want to do? Do you want me to take the whole matter under submission, or do you want me simply to rule at the earliest possible time with or without additional argument?

Mr. Williamson: Your Honor, plaintiff, I think, has adequately stated its position through the pretrial brief and the evidence introduced here. We see no further reason for delay in the decision, and if the Court feels inclined to rule from the bench, it's satisfactory with us.

Mr. Sayre: Your Honor, as requested in the pretrial [4] memorandum, I would like the opportunity, once the facts and inferences the Court mentioned had been established at the trial, to highlight those in written argument by way of a post-trial brief.

I believe that the factors requested by the Court with regard to—as highlighted in the cases that I cited to the Court the other morning could more appropriately have been made in a written argument than they were in the oral statement. I would request the opportunity to argue those to the Court in a post-trial brief. I believe that while the case is fresh on my mind that within a period of 20 days I can file a memorandum. The reason being that the holiday delay here at the present time will necessitate a short delay in getting back to my typist in the office.

Mr. Williamson: Your Honor, I might point out that the Government itself admitted in the pretrial conference he

thought the facts were—there would be no substantial dispute as to the facts. The Court solicited from the Government a further pretrial brief to fully state his position and the cases on which he relied and the facts on which he relied. The Government didn't elect to do so, and I see no reason in further briefing the thing again.

The Court: Well, I indicated when I started that I do not consider myself an expert in the tax field, and I am going to give the Government an opportunity to submit a brief [5] based upon now a fully developed record, but with some limitation in this respect: I am going to make one or two findings and conclusions simply to avoid the necessity of anyone wasting time on certain matters.

I think the heart of the matter here is whether, as the Government states it, Frank Lyon is, for tax purposes, the owner of the building. I say that because there isn't any question in my mind that under Arkansas law and all the law we are used to applying that Frank Lyon is the owner of the building.

So the only real question is: Is there a different result in the application of the tax laws or the manner in which you apply the tax laws. This gets back to the substance versus form argument, and I am going to give the parties an opportunity to get into that.

I do want to say this: One of the factual issues, so to speak, that has been tendered has been resolved beyond any question from what I have heard here. There is no basis from which anyone could find on this record that Worthen will exercise the option at the end of the 11 years or at any subsequent option period. The evidence makes it quite clear that it is highly improbably that it will exercise that option at the eleventh year and very unlikely it will exercise it thereafter, but it has the legal right to do so.

I am simply making this determination that there is [6] no factual basis for the Commissioner to determine or for this Court to determine or for any tryer of fact to determine, upon the basis of what we have heard here, that Worthen will do it.

I think all we have is the admission and the conceded position that they have the legal right to. The evidence would indicate that it is highly unlikely that they will because it will probably not be in their best interest to do so. The farther down the line you look the less concrete can be your prediction, but that, I think, is quite clear.

Now there is another thing from a legal point of view in terms of the substance, if you will, that I don't think the parties need to worry about: I am going to look very hard at the question of who owns that building in the terms of the legal realities and the arguments that you present to me.

If it turns out you are able to convince me—and I think I am looking at you because I really feel that at this juncture the Government needs to convince me that Frank Lyon Company is not the owner, for tax purposes, of this building. If it turns out that it is not, though, and you can show me the indices by which the courts have decided this should be considered to be Worthen's building, there is one other conclusion and factual determination that is quite obvious—that is, that if the relationship is not what it says it is, it is also not a loan. There is no loan here. There is no obligation or agreement to repay the $500,000.00, and there is [7] no agreement enforceable by the lender to obtain repayment of his loan or to obtain the so-called "interest". So you will have to tell me what it is if it's not a loan and if, in fact it is that Worthen does own the building.

Those two determinations are all that I am going to make. They are facts and they are tied together very closely

because the whole concept or idea of the loan really is tied to the Government's theory that they will exercise the option and unless the mere right to exercise it is enough to create the irrebuttable presumption that they will, there is certain no evidence to indicate that the option will be exercised.

With those limited comments, I want to hear and see particularly I would like to see the Government analyze the sale-lease back transaction and show me the ones where the arrangement is satisfactory for tax purposes and then how this deviates and those cases which indicate that these other circumstances which we have here would make it not be the true owner.

If it turns out the agent did not make much of or anything of the fact Mr. Lyon was on the board of Worthen and was also on the board of the other company—the close relationship apparently did not in any way affect it, nor do I know of any law which makes a transaction between those closely connected businesswise unacceptable.

He emphasized the fact Worthen pledged other asset [8] to assist in obtaining the interim and permanent financing. He emphasized the option to repurchase. He emphasized the fact that the agreement rentals were exactly equal to the loan payment on the permanent financing and that, therefore, the plaintiff was, as he put it, a conduit. So I would like to know this: Does it become less objectionable if the amounts are below or above the exact amount that is required to discharge that?

The ground lease thing impressed the agent. I know that what the agent determines is not binding upon the Government, but these are the factors that resulted in this case being here. Frankly, having listened to all the testimony, I would need you to point out how that is important because it occurs to the Court, as testified by every witness that testified, that if you put it at a rea-

sonable sum instead of $50.00 they simply raise the rent by that much.

So there is nothing that the Court can see, on the basis of the testimony in the record, that would change the transaction if you have it a reasonable rent, as you put it, for the ground instead of a nominal rent because it could be passed on and would just simply be a circuitous transaction. If it were $100,000.00 instead of $50.00, it would come right back by way of increased rent.

He was impressed by the fact the tenant had all the instances, in effect, of ownership in the sense of [9] control of the building, responsibility for the loss or damage, maintenance, upkeep, and so forth.

He, I think, was impressed by the fact if you took the amount of the down payment, $500,000.00, and you assumed Worthen would exercise the option and read the record that indicated they were looking at a six percent return, that, in effect, would return six percent at the end of 11 years if Worthen exercised that option.

That, of course, is clear to the Court from the evidence, is the least that the Lyon Company could make out of this transaction—that is, the tax benefits and the economic benefits if Worthen exercised the option at the end of 11 years.

In any other posture it gets better in terms of the benefits to Frank Lyon Company. Even on the so-called least picture they make substantial returns as evidenced by the agent's figures, based upon either the pre-1969 or the post-1969 Code: approximately $600,000.00 plus in tax benefits under the pre and about $300,000.00 under the post, and in either case approximately the same amount, three hundred something thousand dollars, in clear economic benefit upon his investment of $500,000.00.

I will give you until—this is the 27th. I will ask the parties to file simultaneous briefs by the 20th of December,

and then you will be given until the 27th to respond [10] to your adversary's memorandum.

Mr. Williamson: That's December 27th, Your Honor?

The Court: That is bad, isn't it?

Mr. Sayre: Your Honor, 'm going to be out of the country from the 20th until about the 30th of the month. I plan to take a vacation to Mexico. If we could have, say, until the 7th of January, which would be after the holiday period, that would give us a week.

The Court: All right. You will have until the 20th to file your original memoranda and until, say, the 7th of January to reply.

Mr. Williamson: Thank you, Your Honor.

On other point. Is there any serious question—with reference to what points need to be briefed, is there any serious question in the Court's mind as to the deductibility of interim interest—the interest on the interim financing?

The Court: I am leaving all issues open and see what benefit I get from the work of the attorneys.

Mr. Sayre: Excuse me, Your Honor. You made the finding there was no loan of the $500,000.00. That would eliminate the accrual of interest issue; is that correct?

The Court: Well, I am not eliminating any issue. I am simply saying that if I know what a loan is, which is where one party gives to another party certain money to use for a certain period of time and expects it back at some time, [11] usually in return for a certain so-called interest or money in consideration for the use thereof, there is no legal obligation for either of those items: to repay principal or any interest, as such.

All right.

Court will be in recess.

* * *

at the end of any subsequent option period.[2] Absent action by Worthen, there is no way that plaintiff can obtain repayment of the so-called "loan".

Plaintiff holds the legal title to the building under Arkansas law and is for tax purposes, too, the owner thereof. It bears the burden of depreciation and obsolescence.

The defendant does not contest the unreasonableness of the rental charge for the building. The Court has already indicated in open court that the reasonableness of the annual rent under the ground lease was really immaterial because under the arrangement it was essentially a wash-out item.

The plaintiff had mixed motivations for wanting to enter into the transaction, in addition to receiving the benefits of the tax shelter involved: in addition to the good after-tax rate, the plaintiff had a need to diversify its holdings and a need to use its accumulated earnings. There was also the long-term return on the investment which could be expected when the mortgage indebtedness was retired.

At this time I direct the attorney for the plaintiff to prepare and submit to the defendant, for its approval as to form, a precedent judgment in conformity with this letter-memorandum and the factual findings and legal conclusions stated in open court at the conclusion of the case. The Court will also *consider* making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975. The precedent judgment shall be submitted by June 4, 1975.

Yours very truly,

/s/ G. Thomas Eisele
G. Thomas Eisele

[2] Worthen's future capital requirements and the option prices stipulated on the one hand and the reasonable rentals stipulated on the other make this quite clear. Because of the unlikelihood, the improbability, that the option will be exercised, there is no basis to the Government's contention that it is acquiring an equity in the property through its payment of rent.

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Supplementary Findings of Fact and Conclusions of Law

(Filed June 11, 1975)

In open court at the end of the trial and by Letter Memorandum of May 16, 1975, the Court made certain findings of fact and conclusions of law in this proceeding. In the Letter Memorandum of May 16, the Court indicated to the attorneys for the parties that it would "consider making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975." The plaintiff submitted "Proposed Findings of Fact and Conclusions of Law" prior to May 30, 1975. Defendant has submitted none.

Although the Court usually does not make findings with respect to uncontested or noncontroverted facts such as those contained in the "Proposed Findings of Fact" 1 through 7 and 10 through 13, it will supplement its findings of fact in this case by adopting said proposed findings since the facts stated are true and were never really at issue in the case. The Court has already made findings of fact in the matters referred to in "Proposed Findings" numbered 8 and 9. The proposed findings are accurate, but are simply a restatement of the facts previously found by the Court.

The "Proposed Conclusions of Law" submitted by the plaintiff are accurate statements insofar as they refer to the law involved, but most of the proposed additional conclusions are unnecessary in the light of the Court's rulings. The Court will, however, adopt "Proposed Conclusions"

numbered 4, 6, 8, and 9 as supplements to, or a further statement of, its prior conclusions.

For the purpose of identifying the supplementary findings of fact and conclusions of law proposed by the plaintiff, the Court attaches hereto, and makes a part hereof, the submission by the plaintiff entitled "Proposed Findings of Fact and Conclusions of Law".

Judgment will be entered this date pursuant to the rulings in open court, the Letter Memorandum of May 16, 1975, and the findings of fact and conclusions of law adopted herein.

Dated this 11 day of June, 1975.

/s/ GARNETT THOMAS EISELE
Garnett Thomas Eisele
United States District Judge

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Proposed Findings of Fact and Conclusions of Law

FINDINGS OF FACT.

1. During 1965, Worthen Bank & Trust Company ("Worthen") began to plan the construction of a new multistory bank and office building to replace its old bank building in Little Rock, Arkansas. About the same time Union National Bank of Little Rock ("Union") also began to plan the construction of a new bank and office building. Adjacent sites were acquired by both banks on Capitol Avenue, separated only by Spring Street. It became a matter of competition and prestige between the two banks as to which bank would start and complete its building first.

2. Worthen initially planned to finance the estimated $9,000,000 cost of its site, new building and parking facility by selling $4,000,000 of debentures and using the proceeds to purchase $4,000,000 of capital stock of a wholly owned real estate subsidiary, which would then raise the remaining $5,000,000 through [-2-] a conventional mortgage loan on the new premises. This plan was abandoned for two reasons. As a bank chartered under the laws of Arkansas, Worthen could not pay more than the then statutory limit of 6% on any debentures it might issue, and Worthen was unable to locate a purchaser of the proposed $4,000,000 of debentures at an interest rate of 6% or less. Further, under the provisions of Section 24A of the Federal Reserve Act, prior approval of the Board of Governors of the Federal Reserve System was required if the total investment in bank premises (including any investment in a real estate company holding title to the premises) exceeded

Worthen's capital stock of $4,000,000, and Worthen was informed by staff employees of the Federal Reserve System that they would not recommend approval of the plan by the Board of Governors.

3. Worthen then proposed a new plan involving a sale and leaseback. Both the Federal Reserve Bank of St. Louis and the State Bank Department approved the new plan after required modifications, including a requirement by the State Bank Department that Worthen have an option to repurchase the building after 15 years. Thereafter Worthen conducted detailed negotiations with several investors, including Goldman, Sachs & Co., Eastman Dillon, Union Securities & Co., Stephens, Inc. and plaintiff, resulting in the preparation by Worthen of a "Specification For Sale—Leaseback of Worthen Bank and Office Building", which incorporated the best features from Worthen's point of view of the proposals made by the various investors. These specifications were submitted to Stephens, Inc. and plaintiff was accepted when plaintiff improved its bid by reducing the [-3-] proposed rent $21,000 per year for the first 5 years.

4. Because of its race with Union to complete construction first and prior to the selection of the investor, Worthen obtained a verbal commitment from First National City Bank for interim financing and from New York Life Insurance Company for permanent financing, subject to the lenders' approval of the investors to be selected. Worthen also negotiated a cost-plus construction contract with the general contractors prior to the final selection of the investor. After plaintiff was selected as the investor, plaintiff, Worthen, New York Life and First National City Bank spent five months in hard arm's length negotiations and drafting before finalizing the documents reflecting the agreements between the parties.

5. Worthen leased to plaintiff for 76 years and 7 months the ground under the bank building, sold the building

piecemeal to plaintiff for $7,640,000 as it was being constructed (to meet the requirement of the Federal Reserve Bank that the building not appear on Worthen's books), and then leased back from plaintiff the completed building for a primary term of 25 years, with options to extent the lease for 8 additional terms of 5 years. Plaintiff invested in the building $500,000 from its own working capital and $7,140,000 it borrowed from New York Life Insurance Company on the permanent loan.

6. The annual rent of $582,224 for the first 11 years of the building lease and $613,156 for the next 14 years is the exact amount required to amortize the New York Life loan during the 25-year primary term of the lease. The rent on the building during the option periods totaling 40 years is [-4-] $300,000 per year. The evidence reflected and the Court finds, that the rent to be paid by Worthen during the term of the lease is reasonable, a fact not contested by the defendant.

7. Worthen was given the option to purchase the Worthen Building on the following dates at the following purchase prices:

11-30-80 (after 11 years)	$6,325,169.85
11-30-84 (after 15 years)	5,432,607.32
11-30-89 (after 20 years)	4,187,328.04
11-30-94 (after 25 years)	2,145,935.00

The option price at each date represents the unpaid balance of the New York Life note plus plaintiff's $500,000 plus 6% compounded interest. It also represents the negotiated estimate of plaintiff and Worthen as to the fair market value of the building on the option dates, which the Court finds to be reasonable. The defendant produced no witnesses to contest the reasonableness of the option prices.

8. There has never been any understanding or agreement between Worthen and plaintiff that Worthen will ever exercise any of its options to purchase. Because of Worthen's future capital requirements, the very substantial amounts of the option prices, the reasonableness of the net rents Worthen will be required to pay during the original and extended terms of the building lease and the economic return Worthen earns on its funds not invested in real estate, it is most unlikely and improbable that Worthen will exercise its options to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods.

9. The ground lease requires plaintiff to pay Worthen $50.00 per year for the first 26 years, 7 months (the length of the primary term of the building lease plus the construction period). Thereafter the annual rental under the ground lease [-5-] will be as follows:

12-1-94 thru 11-30-99 (5 years)	$100,000.00
12-1-99 thru 11-30-04 (5years)	150,000.00
12-1-04 thru 11-30-09 (5 years)	200,000.00
12-1-09 thru 11-30-34 (25 years)	250,000.00
12-1-34 thru 11-30-44 (10 years)	10,000.00

The government contends that the ground rent of $50.00 per year during the primary term of the building lease is unreasonably low and indicates that Worthen owns the building. The evidence clearly showed, and the Court finds, that the amount of the ground rent during the first 25 years of the building lease is immaterial: had the ground rent to be paid by plaintiff to Worthen been increased, the building rent to be paid by Worthen to plaintiff would have been increased by the same amount, resultng in a washout.

10. On an audit of plaintiff's income tax return for 1969, the Commissioner of Internal Revenue determined, without further explanation, that plaintiff is "not the owner for

tax purposes of any portion of the Worthen Building. Therefore, the income and expenses related to this building are not allowable to you for Federal income tax purposes." Based upon this determination the Commissioner made the following adjustments to plaintiff's reported income:

1. Accrued rental income for 1 month from Worthen		$(48,527.01)
2. Accrued interest for 1 month owed to New York Life		40,162.50
3. Depreciation for 1 month on Worthen Building		51,618.79
4. Expenses during construction:		
(a) Interest paid to FNCB	$403,899.54	
(b) Legal expense	33,351.05	
(c) Title insurance	10,140.00	
(d) Audit expense	3,475.00	
(e) Telephone and travel	801.16	451,666.75
5. Accrued interest income		2,298.15
Total increase in reported income		$497,219.18

[-6-] 11. Based upon these determinations, the Commissioner assessed an income tax deficiency against plaintiff in the amount of $236,596.36, together with interest in the amount of $43,790.84, making a total deficiency assessment of $280,387.20. (This figure does not include other uncontested adjustments which are not involved in this case). Plaintiff paid the deficiency assessment and filed a claim for refund of the $280,387.20, which claim the Commissioner disallowed. Thereafter plaintiff filed this action to recover the $280,387.20, with interest.

12. The Gevernment contends that, although the "form" of the transaction was a sale and leaseback arrangement,

in "substance" Worthen owned the building; that plaintiff was a mere "conduit" of the interim loan from First National City Bank to Worthen and of the permanent loan from New York Life Insurance Company to Worthen; and that plaintiff "loaned" to Worthen the $500,000 which plaintiff invested in the building from its own working capital.

13. The plaintiff contends that for Federal tax purposes the transaction was in "substance" exactly what it was in "form", i.e., a true sale and leaseback transaction, with the interim and permanent loans being in from and substance made to plaintiff rather than to Worthen.

CONCLUSIONS OF LAW

1. It was both the "subjective" and "objective" intention of the parties, as evidenced by their written agreements when read in the light of the attending facts and circumstances existing at the time the agreements were executed, that the transaction [-7-] be a sale-leaseback with options to repurchase, exactly in accordance with the form and language of the documents evidencing the transactions. Any other view of the case would not only produce strange and untenable results but would be both unjust to plaintiff and contrary to the intent and purposes of the applicable federal tax laws. *Western Contracting Corporation* v. *Commissioner,* 271 F.2d 694 (8 Cir. 1959); *Arkansas Bank and Trust Company* v. *United States,* 224 F. Supp. 171 (D.C. Ark. 1963).

2. Plaintiff owns the Worthen Building, both under Arkansas law and for federal income tax purposes. Because of the improbability that plaintiff will exercise any of its options to purchase, there is no basis for the defendant's contention that Worthen is acquiring an equity in the property through the payment of rent. Since the parties in good faith actually intended to enter into a sale-leaseback transaction, Worthen will acquire an equity in the

property only if and when it ever exercises any of its options to purchase. Until the option to purchase is exercised, plaintiff bears the burden of the depreciation and obsolesence of the building. Defendant did not question the method or rate of depreciation used by plaintiff. Plaintiff is entitled to deduct the depreciation claimed on the building in its 1969 return. *Breece Veneer and Panel Company* v. *Commissioner,* 232 F.2d 319 (7 Cir. 1956); *Benton* v. *Commissioner,* 197 F.2d 745 (5 Cir. 1952); *Kearney & Trecker Company* v. *United States,* 195 F. Supp. 158 (ED Wisc. 1961).

3. Plaintiff was not a mere "conduit" for loans to [-8-] Worthen by First National City Bank and New York Life Insurance Company, as contended by the defendant. Plaintiff was the borrower and sole obligor on the loan and on the permanent loan. The interim and permanent lenders made independent investigations of plaintiff's financial stability, negotiated with plaintiff for almost six months over the details of the loans and in all respect intended and treated plaintiff as the borrower. The fact that Worthen negotiated tentative commitments for the loans prior to the selection of plaintiff as the investor does not indicate that Worthen was the borrower; it simply enabled Worthen to attract more potential investors and to obtain a lower rent. The fact that the rents were no less than the amount required to amortize the permanent loan was a requirement of New York Life Insurance Company; the fact that the rents were no more is only a reflection of the relatively small initial equity required of the investor and of the intensity of the competition among the potential investors for the investment. Plaintiff is entitled to deduct the interest paid and accrued on the interim and permanent loans.

4. Plaintiff is entitled to allocate and deduct its expenses incurred in obtaining the interim loan and permanent loan over the lives of the respective loans to which they relate.

Detroit Consolidated Theatres, Inc. v. *Commissioner*, 133 F.2d 200 (6 Cir. 1943); *Anover Realty Corp.*, 33 T.C. 671 (1960). Plaintiff is entitled to allocate and deduct over the life of the building the expenses incurred in acquiring the building. Plaintiff and defendant have stipulated the proper allocation of such expenses.

[-9-] 5. Even if the Court had found that Worthen owned the building for federal income tax purposes and was entitled to the depreciation deduction, plaintiff would still have been entitled to deduct the interest it paid on the interim and permanent loans and to allocate and deduct the expense it incurred in obtaining the interim and permanent loans and title to the building. *Rev. Rul. 72-543.*

6. The theory of the defendant that plaintiff "loaned" $500,000 to Worthen is completely untenable, both in fact and in law. There was no obligation or agreement by Worthen to repay the $500,000 and no way plaintiff could force the repayment. The only way plaintiff could ever receive the $500,000 from Worthen would be through the exercise by Worthen of one of its options to repurchase, an event entirely within the discretion of Worthen and highly improbable. Consequently, the Commissioner erred in assuming that Worthen will exercise its option at the end of the eleventh year of the building lease, and in determining that plaintiff's anticipated $303,356 gain on the assumed exercise of the option is the equivalent of interest which plaintiff must accrue as income evenly over the first eleven years of the lease. Regulations 1.446-1(c)(ii).

7. The defendant placed considerable emphasis upon the fact that, assuming plaintiff exercised its option to purchase at the end of the first eleven years of the lease, plaintiff's deduction for depreciation on the building would generate an operating loss deductible against other income of plaintiff which would result in the net tax saving to plaintiff of $312,220.45 over the eleven year period. (Defend-

ant's Exhibit 6). Defendant [-10-] argued that plaintiff's only reason for investing in the building was to obtain this tax saving, and that a device to minimize tax liability, with no additional business purpose, will be disregarded for tax purposes. Defendant's argument on this point is in error for several reasons. First, the evidence clearly reflects, and the Court finds, that plaintiff was motivated to enter into the transaction, not only because of the good current after-tax return offered by the investment, but because of plaintiff's need to diversify its holdings, the need to use its accumulated earnings to avoid a Section 531 tax, and the anticipated long-term return on the investment after the permanent loan was retired. Secondly, the form of the transaction was determined by Worthen within guidelines established by banking law restrictions having nothing to do with tax motives; substantially the same terms had been negotiated with other potential investors before plaintiff entered the picture. The reality of the transaction for tax purposes cannot be unilaterally determined solely by plaintiff's intent or motives. *Breece Veneer and Panel Company* v. *Commissioners*, supra, at 323. Thirdly, it is highly unlikely that the option will be exercised at the end of the first eleven years of the lease, after which time the building lease will generate a substantial taxable income to plaintiff. Finally, the fact that plaintiff will receive a tax benefit during the early years of the investment is in keeping with the intent of Congress to stimulate investments in depreciable real estate through accelerated depreciation deductions: it does not suggest that [-11-] the substance of the transaction was not in keeping with its form. Plaintiff has the legal right to decrease the amount of what otherwise would be his taxes by means which the law permits. *Gregory* v. *Helvering*, 293 U.S. 465 at 469 (1935).

8. The agreement of Worthen, as lessee under the Building Lease, to pay all taxes, insurance and maintenance on the building, to hold the lessor harmless from all claims

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

Notice of Appeal

(Filed August 11, 1975)

Notice is hereby given that the United States of America, defendant herein, appeals to the United States Court of Appeals for the Eighth Circuit from the judgment entered in favor of plaintiff on June 11, 1975.

UNITED STATES OF AMERICA
/s/ W. H. DILLAHUNTY
By W. H. Dillahunty
United States Attorney

(Certificate of Service Omitted in Printing)

Supreme Court, U. S.
FILED
APR 25 1977
MICHAEL RODAK, JR., CLERK

APPENDIX

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Appellant*,

v.

UNITED STATES OF AMERICA, *Appellee*.

ON PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

VOLUME II

(Pages 313-748)

PETITION FOR WRIT OF CERTIORARI FILED NOVEMBER 3, 1976
CERTIORARI GRANTED FEBRUARY 22, 1977

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Appellants*

v.

UNITED STATES OF AMERICA, *Appellee*

Petition for Writ of Certiorari Filed November 3, 1976

Certiorari Granted February 22, 1977

INDEX

	Page
Complaint, filed September 27, 1973	6
Answers, filed November 26, 1973	8
Stipulation, filed September 16, 1974	9
Supplemental Stipulation, filed December 23, 1974	14
Transcript of Proceedings, November 26, 1974	17
Supplementary Findings of Fact and Conclusions of Law, filed June 11, 1975	299
Proposed Findings of Fact and Conclusions of Law	301
Judgment, filed June 11, 1975	311
Notice of Appeal, filed August 11, 1975	312

	Page
Plaintiffs' Exhibit 1: Letter dated August 26, 1967 from Edward M. Penick, President of Worthen Bank & Trust Company to O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis	313
Plaintiffs' Exhibit 2: Letter dated September 1, 1967 from Edward M. Penick to O. O. Wyrick	322
Plaintiffs' Exhibit 3: Letter dated September 12, 1967 from Edward M. Penick to O. O. Wyrick	324
Plaintiffs' Exhibit 4: Letter dated September 13, 1967 from O. O. Wyrick to Edward M. Penick	326
Plaintiffs' Exhibit 5: Letter dated September 1, 1967 from Edward M. Penick to H. C. Adams, Commissioner of State Bank Department	328
Plaintiffs' Exhibit 6: Letter dated September 5, 1967 from H. C. Adams to Edward M. Penick	336
Plaintiffs' Exhibit 7: Letter dated September 12, 1967 from Edward M. Penick to H. C. Adams	338
Plaintiffs' Exhibit 8: Letter dated September 13, 1967 from H. C. Adams to Edward M. Penick	339
Plaintiffs' Exhibit 9: Sale and Leaseback proposal dated September 28, 1967 to Goldman, Sachs & Co.	340
Plaintiffs' Exhibit 10: Revised Sale and Leaseback proposal dated October 27, 1967 of Stephens, Inc.	344
Plaintiffs' Exhibit 11: Letter dated October 30, 1967 from Frank Lyon to Worthen	346
Plaintiffs' Exhibit 12: Comparison of financing plans of Frank Lyon, Stephens, Inc. and Goldman, Sachs & Co.	348
Plaintiffs' Exhibit 13: Specification for Sale-Leaseback of Worthen Bank Building dated October 31, 1967	349
Plaintiffs' Exhibit 14: Letter dated November 1, 1967 from Frank Lyon to Worthen containing Lyon's proposal number 2	352
Plaintiffs' Exhibit 15: Comparison of financing plans dated November 2, 1967	355

Page

Plaintiffs' Exhibit 16: Letter dated Noevmber 30, 1967 from Alan W. Peters, Vice President of First National City Bank to Edward M. Penick 356

Plaintiffs' Exhibit 17: Letter dated December 18, 1967 from Richard W. Baker, Jr., Vice President of New York Life Insurance Company to Frank Lyon Company 358

Plaintiffs' Exhibit 18: Ground Lease dated May 1, 1968 between Worthen Bank & Trust Company, as Lessor, and Frank Lyon Company, as Lessee.... 366

Plaintiffs' Exhibit 19: Building Lease dated May 1, 1968 between Frank Lyon Company, as Lessor, and Worthen Bank & Trust Company, as Lessee. 376

Plaintiffs' Exhibit 20: Note Purchase Agreement dated May 1, 1968 between Frank Lyon Company and New York Life Insurance Company 443

Plaintiffs' Exhibit 21: Building Loan Agreement dated May 14, 1968 between Frank Lyon Company and First National City Bank 462

Plaintiffs' Exhibit 22: Building Loan Mortgage Note for $7,000,000 dated May 14, 1968 from Frank Lyon Company to First National City Bank 488

Plaintiffs' Exhibit 23: Building Loan Mortgage dated May 14, 1968 from Frank Lyon Company and Worthen Bank & Trust Company to First National City Bank 490

Plaintiffs' Exhibit 24: Assignment dated May 14, 1968 from Frank Lyon Company to First National City Bank 503

Plaintiffs' Exhibit 25: Sales Agreement dated May 19, 1968 between Frank Lyon Company, as purchaser, and Worthen Bank & Trust Company, as seller .. 508

Plaintiffs' Exhibit 26: Secured Note dated December 1, 1969 for $7,140,000 from Frank Lyon Company to New York Life Insurance Company 523

Page

Plaintiffs' Exhibit 27: First Deed of Trust dated December 1, 1969 from Frank Lyon Company and Worthen Bank & Trust Company to Darrell D. Dover and New York Life Insurance Company... 527

Plaintiffs' Exhibit 28: Assignment dated December 1, 1969 from Frank Lyon Company to New York Life Insurance Company 571

Plaintiffs' Exhibit 29: Consent and Agreement dated December 1, 1969 of Worthen Bank & Trust Company to New York Life Insurance Company 575

Plaintiffs' Exhibit 32: Specimen bank statement of Frank Lyon's account at First National City Bank with specimen checks and credit ticket attached.. 584

Plaintiffs' Exhibit 33: Comparative consolidated balance sheets of Frank Lyon Company and subsidiaries as of December 31, 1969 and 1968 587

Plaintiffs' Exhibit 34: Comparative consolidated statement of income years ended December 31, 1969 and 1968 of Frank Lyon Company and subsidiaries 589

Plaintiffs' Exhibit 35: Guaranty dated May 14, 1968 from Edward M. Penick, President of Worthen Bank & Trust Company to First National City Bank of New York 591

Plaintiffs' Exhibit 36: Computation of tax loss on Worthen Building of Frank Lyon Company for years 1969 through 1993; years 2007 through 2019 and years 2033 through 2044 595

Plaintiffs' Exhibit 37: Letter dated August 22, 1967 from O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis to Edward M. Penick, President of Worthen Bank and Trust Company of Little Rock, Arkansas 597

Plaintiffs' Exhibit 38: Summary of Conservation with Mr. O. O. Wyrick dated September 6, 1967 599

Plaintiffs' Exhibit 39: Letter dated September 20, 1967 from Mr. Theodore M. Siouris, A General Partner to E. M. Penick, President of Worthen Bank & Trust Company in reference to Sale-Leaseback Financing of New Bank Headquarters 601

Page

Plaintiffs' Exhibit 40: Letter dated April 16, 1968 from Edward Penick, President of Worthen Bank and Trust Company to Mr. H. C. Adams, State Bank Commissioner, Little Rock, Arkansas 609

Plaintiffs' Exhibit 41: Letter dated April 16, 1968 from Edward Penick, President of Worthen Bank and Trust Company to Mr. O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis.. 613

Plaintiffs' Exhibit 42: Letter dated April 19, 1968 from O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis to Mr. Edward M. Penick, President, Worthen Bank and Trust Company... 618

Plaintiffs' Exhibit 43: Letter dated April 22, 1968 from James Penick, Jr., Executive Vice President of Worthen Bank and Trust Company to Mr. O. O. Wyrick, Vice President, Federal Reserve Bank of St. Louis 620

Plaintiffs' Exhibit 44: Letter dated April 23, 1968 from O. O. Wyrick, Vice President, Federal Reserve Bank of St. Louis to Mr. James Penick, Jr., Executive Vice President, Worthen Bank & Trust Company 622

Plaintiffs' Exhibit 45: Comparison of annual rent with total of depreciation and interest for first 10 years of Worthen Bank Building 623

Plaintiffs' Exhibit 46: Worthen Bank & Trust Co. Rent Schedule on Worthen Building 1944 624

Plaintiffs' Exhibit 47: Safeway Lease 625

Plaintiffs' Exhibit 48: Inter-office communication dated May 13, 1969 from B. H. Dean, Jr. to James A. Rowland for Mr. W. H. Dodge regarding Safeway Lease 641

Plaintiffs' Exhibit 49: Letter dated July 28, 1971 from James B. Bolen, Jr. to T. H. Mayer and Nicholas M. Mayer enclosing Safeway Lease 663

Plaintiffs' Exhibit 50: Letter dated April 12, 1968 from Frank Lyon Company to Ed Penick, President, Worthen Bank and Trust Company 686

Page

Plaintiffs' Exhibit 51: Letter dated April 26, 1974 from Rudy Landry, Investment Officer of Cabot, Cabot & Forbes Equity Trust to Mr. Frank Lyon, Chairman of the Board, Frank Lyon Company 687

Plaintiffs' Exhibit 52: Explanation of Items of Frank Lyon Company 689

Defendants' Exhibit 1: Equity interest in land and buildings of Worthen Bank & Trust Co. 691

Defendants' Exhibit 2: Cash Flow, Frank Lyon Co.-Worthen Building 692

Defendants' Exhibit 3: Loss from Rental Operation, Frank Lyon Co.-Worthen Building 693

Defendants' Exhibit 4: Gain on Sale 1980 if 1980 Option is Exercised, Frank Lyon Co.-Worthen Building 604

Defendants' Exhibit 5: Tax Consequences vs. Economic Gain if 1980 Option is Exercised, Frank Lyon Co.-Worthen Building 695

Defendants' Exhibit 6: Tax Benefit—if Option Exercised November 30, 1980, Taking 1969 Tax Reform Act into Account, Frank Lyon Co.-Worthen Building 696

Defendants' Exhibit 7: Schedule of Direct Reduction Loan, Frank Lyon Company, Loan from New York Life (Schedule December 16, 1969) 697

Defendants' Exhibit 11: Letter dated November 28, 1969 from Frank T. McGehee, Assistant Vice President of Worthen Bank and Trust Company to New York Life Insurance Company 701

Defendants' Exhibit 12: Letter dated November 25, 1969 from Members American Institute of Certified Public Accountants of Gotham, Wyman & Howland to New York Life Insurance Company.. 705

Defendants' Exhibit 13: Letter dated September 2, 1966 from Richard F. Gates, Vice President to Mr. Harry E. Meek, Attorney, Little Rock 707

Page

Defendants' Exhibit 14: Letter dated October 13, 1966 with enclosures from Harry E. Meek, Attorney to Worthen Bank & Trust Company 708

Defendants' Exhibit 15: Letter dated September 8, 1967 from C. J. Giroir, Jr., Attorney to Worthen Bank and Trust Company 734

Defendants' Exhibit 16: Inter-office communication dated August 11, 1967 from Richard F. Gates to Edward M. Penick regarding financing of bank building (pp. 1 and 2, and 8-10) 742

P. Ex. 1

WORTHEN BANK AND TRUST COMPANY
ESTABLISHED 1877

LITTLE ROCK, ARKANSAS

August 26, 1967

Mr. O. O. Wyrick, Vice President
Federal Reserve Bank of St. Louis
Post Office Box 442
St. Louis, Missouri, 63166

Dear Mr. Wyrick:

The attached brochure and statements reflect information relating to the construction by Worthen Bank of a new main office, office building and parking facility to cost between $8,500,000.00 and $9,000,000.00. The building site is being acquired from Urban Renewal and is located on Capital Avenue between Louisiana and Center Streets, comprising approximately three-quarters of a block.

Taking $9,000,000.00 as the total construction cost, it is contemplated that we will issue $4,000,000.00 non-convertible debentures, maturing in 25 years, to be retired by a sinking fund beginning the eleventh year. The balance of the funds would be raised by the negotiation of a mortgage loan for $5,000,000.00 through a wholly owned subsidiary with principal payments beginning the fourth year.

Interest payments on debentures at an assumed rate of 6½ would be $260,000.00 per annum and interest payments on the mortgage loan until principal reductions are begun, assuming a 6½ per annum rate would be $325,000.00 for a total interest cost during the first three years of $585,000.00.

The combination of debentures, totaling $4,000,000.00 which will be used to purchase stock of the subsidiary, and a mortgage loan negotiated by the subsidiary will pay the entire cost of land and building totaling $9,000,000.00.

Operating statements submitted reflect the results of the occupancy of the new building by Worthen Bank in the middle of 1969, by projecting growth in earnings and expenses for the period 1968 through 1973 deducting therefrom the occupancy expense of present building and adding expense of occupancy in the new building. We also project cost of space vacant until building is fully occupied by tenants as a bank expense. The pro forma statement of the subsidiary is based on estimates of tenant occupancy after approximately a three year period and highlights the need for adjusting the banks rental payments to meet varying costs of the subsidiary. The pro forma balance sheets merely show the results of issuing the debentures by the bank and the placing of the mortgage by the subsidiary. We propose to sell our present main office facility, hopefully before we move into the new building. The present facility, including fixtures and equipment, is carried on our books at a depreciated value of $786,526.29.

The attached schedule of the cost of construction are the budgeted figures agreed upon by the architects, Erhart, Eichenbaum, Rauch & Blass, and the contractors, being Matson Construction Company of Little Rock, Ark. and Bellows Construction Company of Houston, Texas, in consultation with Carl E. Morse Company, Consultants, of New York City.

We expect to begin construction as soon as we have received approval from you and have arranged the financing, subject of course, to approval by the Board of Directors and State Supervisory Authorities. The construction is expected to be completed within 18 months from the date it is begun.

Your early consideration will be appreciated and of course, we will promptly furnish any additional information you may require.

Sincerely,

/s/ Edward M. Penick
President

Worthen Bank and Trust Company

Construction Cost		
Bank & Office Building, 238,255 gross sq. ft. @ 22.82		5,436,600
5 Level Parking, 110,880 gross sq. ft. @ 6.00		665,280
Architects Fee—estimated		259,000
Financing Charges—estimated		378,000
Consultant Fees		162,000
Land		
60,650 sq. ft. @ 23.53 per sq. ft.		1,425,000
Estimated Project Cost		8,325,880
Estimated Cost of Equipment		
Vault Equipment	32,000	
Under Counter Equip.	12,000	
Pneumatic Equip.	10,000	
T.V. Teller	125,000	
Kitchen-dining Equip.	150,000	329.000
Carpeting	42,000	
Drapes	20,000	
Built-ins	75,000	
Furniture	80,000	217,000
		546,000
Total Construction, Financing & Equipment Cost		$6,871,880

Worthen Bank and Trust Company

Statement of Earnings, Pro Forma (Amount in Thousands)

Sale of Non-Convertible Debentures $4,000,000 @ 6½%

Mortgage Through Subsidiary $5,000,000 @ 6½%

December 31, 1966 Net Operating Earnings adjusted for Interest Cost of Financing

	Present Worthen Statement	Pro-Forma Worthen Statement	Pro-Forma Real-Estate Subsidiary	Adjustments	Pro-Forma Consolidated Statement
Operating Income:					
Int. & Div. on Sec.	985	985			985
Int. & Div. on Loans	5,359	5,359			5,359
Service Cgs. on Loans	39	39			39
Service Cgs. on Dep. Accounts	528	528			528
Other Service cgs., comms., fees & Collection charges	49	49			49
Fee-Trust Department	170	170			170
Other Income	156	156			156
Rental Income:					
Worthen Bank			565(5)	(565)	
Others			281(6)		281
Parking			66(7)		66
Total	7,285	7,286	912		7,633
Operating Expense:					
Salaries	1,850	1,850			1,850
Other Personnel Expense	402	402			402
Interest	1,911	2,171(1)	325(3)		2,496
Occupancy	296	669(2)	587(4)	(565)	691
Furniture & Equip.	308	308			308
Other Expenses	1,179	1,179			1,179
Total	5,946	6,379	912		6,926

Operating Income over Expense	1,340	707	—0—		707
Applicable Federal Income Tax	367	51(8)	—0—		51
Net Operating Earnings	973	656			656

(1) Increased by $260,000 interest on Capital Notes.

(2) Increased by $565,000 which is rental paid Subsidiary on new building less $192,321.37 decrease in occupancy expense on old building & motor bank.

(3) Increase on First Mortgage Note.

(4) Depreciation of $175,000.00 and occupancy expense on new building of $412,481.00.

(5) Rental paid by Worthen to Subsidiary, plus figures used to make Subsidiary non-profit.

(6) Rental income from tenants 78,062 sq. ft. @ 4.50 per with 30% occupancy.

(7) Parking rental income (275 cars x 1.00 x 28 days x 12 months.

(8) Reduced taxes 50% of the additional $633,000 expense or $316,000 tax reduction over last period.

Worthen Bank and Trust Company

Pro Forma Balance Sheet

Adjusted to 6-30-67 • Balance Sheet as of 6-30-69
(0's omitted)

	6/30/67	Adjustments for financing	Completion of bldg. 6/30/69
Cash	38,488		38,488
U.S. Government Obligations	13,703		13,703
Obligations U.S. Instrumentalities	1,119		1,119
State & Municipal Obligations	11,527		11,527
Loans & Discounts	87,538		87,538
Loans Guaranteed by CCC	6,440		6,440
Stock in Federal Reserve	270		270
Bank Bldg. Vault & Equipment (1)	1,833		1,833
Cash Value Life Ins. —Officers	149		149
Investment in Subsidiary		4,000	4,000
Other Resources	328		328
Total Resources	161,395		185,395
Capital Stock	4,000		4,000
Surplus	5,000		5,000
Capital Notes		4,000	4,000
Undivided Profits & Reserves	2,496		2,496
Reserve for Unearned Interest	2,704		2,704
Deposits	147,195		147,195
Total Liabilities	161,395		185,395

Note: (1) This includes present main-office land, building & equipment carried @ depreciated amount of $786,-526.29.

Worthen Bank and Trust Company

Pro Forma Operating Statement 1968-1973

(Amount in Thousands)

	1968	1969	1970	1971	1972	1973
Operating Earnings	9,300	10,400	11,400	12,450	13,500	14,500
Operating Expenses (5)	7,600	8,500	9,450	10,400	11,300	12,200
Profit before taxes & additional cost allocable to new building	1,700	1,900	1,950	2,050	2,200	2,300
	1,700	1,900	1,950	2,050	2,200	2,300
Plus: Occupancy Expense old building		90	192	192	192	192
	1,700	1,990	2,142	2,242	2,392	2,492
Less: Interim Financing Interest	200,00	178				
Rental		300	557	557	557	557
Vacant Tenant Space		150	144(2)	108(3)	72(4)	72
Adjusted Parking		25	16			
Total Deductions	200,000	653	717	665	629	629
Net before taxes	1,500	1,337	1,425	1,577	1,763	1,863
Taxes (1)	400	356	379	419	469	496
Net Operating Earnings	1,100	981	1,046	1,158	1,294	1,367

(1) Taxes are figured at 26.6% of Net Profit before taxes.

(2) 40% of tenant rental—331,000

(3) 30% of 361,000

(4) 20% of 361,000

(5) Interest on Debentures included.

Worthen Bank and Trust Company

Real Estate Subsidiary

Pro Forma Balance Sheet

Assets	
Land	$1,425,000
Bank Building	$7,575,000
Total Assets	$9,000,000
Liabilities	
Mortgage Note	$5,000,000
Capitalization	
Capital Stock	$4,000,000
Total Liabilities	$9,000,000

Worthen Bank and Trust Company

Real Estate Subsidiary

Pro Forma Operating Statement— 3 Years After Occupancy

INCOME			
Bank (1)	114,549 @ $4.86 per sq. ft.		567,054
Tenant	78,062 @ $4.627 per sq. ft.		361,248
Parking	110,880 (275 cars x 1.00 x 20 days x 12 mos.)		66,000
			984,302
Less:	15% vacancy factor tenant space 78,062 x 15% x 4.627		54,177
Estimated Annual Income			$930,125
EXPENSES			
Bldg. Operation 192,611 sq. ft. @ 1.50		288,916	
Parking Operation 110,880 sq. ft. @ .12		13,305	
Real Estate Taxes (estimated)			
Land	19,760		
Building	90,500	110,260	412,421
Estimated Net Income before Depreciation			$517,644
Depreciation (50 yr. st. line)			151,500
Net Income			$366,144

NOTE: (1) Amortization of $5,000,000. loan @ 6½% for 27 years is $393,500 per year. This exceeds rental being estimated by bank by $27,356. Adjustments would need to be made in bank rental paid to subsidiary for any losses of subsidiary.

P. Ex. 2

WORTHEN BANK AND TRUST COMPANY
ESTABLISHED 1877

LITTLE ROCK, ARKANSAS

September 1, 1967

Mr. O. O. Wyrick, Vice President
Federal Reserve Bank
P.O. Box 442
St. Louis, Missouri 60602

Dear Mr. Wyrick

I have discussed with Mr. Harvel Adams, Arkansas State Bank Commissioner, and Mr. Kenneth Sanders, assistant bank commissioner, financing plans on our new building which would involve complete abandonment of the plans Dick Gates and I discussed with you. Under the new proposal we plan to put a portion of the new building cost on our books and handle the balance totaling $7½ million on a sale and leaseback arrangement.

I am enclosing a letter to Mr. Adams which outlines this plan and a copy of the operating figures which reflect the effect of this plan on our operations.

We are presently in negotiations with Goldman & Sachs Company of New York to handle the sale and leaseback.

Mr. Adams has indicated to us that he can give us his approval on this plan right away and we have tentatively scheduled a ground breaking ceremony for Friday afternoon, September 15. I am hopeful that your approval can be received so that we may go ahead with the plans for this ground breaking ceremony as scheduled.

I am also enclosing leasing brochures and a copy of excerpts from the report of Landauer & Associates of New

York regarding the possibility of our leasing this size building.

These items were discussed at our meeting this week, and I promised to send you copies.

Very truly yours,

President

P. Ex. 3

September 12, 1967

Mr. O. O. Wyrick, *Vice President*
Federal Reserve Bank
P. O. Box 442
St. Louis, Missouri 60602

Dear Mr. Wyrick:

In line with our conversation regarding the proposed financing of our building by using the sale and leaseback $7½ million and by putting the balance of the cost of the parking garage and land under the parking garage on our statement, I am submitting to you the estimated cost of this project. These costs have been revised from those previously furnished you in my letter of September 1st by dividing the architect fees, consultant fees, and finance charges between the two buildings, that is the sale and leaseback bank office building and the parking garage.

The item of finance charges is an estimated figure, as we will not be financing any of the building cost on our own statement, but will arrange for the owners-lessors to finance the building themselves. This will work in the following manner. We will convey title to the land on which the bank building and office building will be built to the investors that will own the building and lease it to us. They will put up the money for the cost of construction in an escrow account with a trustee bank and we will take the money down as we need it for construction costs. We will be obligated to pay the difference between what the money costs the investors, if they have to borrow it elsewhere, and what they are able to earn on it as a short term investment from the escrow account. So our financing charges really resolve themselves into being the difference between these two costs. By handling the construction costs in this manner it will at no time become an asset of the

bank and we will not be required to handle an interim financing arrangement.

I would appreciate your approval of the plan as we have outlined it here and in our previous correspondence.

Very truly yours,

President

P. Ex. 4

FEDERAL RESERVE BANK OF ST. LOUIS
P. O. BOX 442
ST. LOUIS, MISSOURI 63166

O. O. Wyrick
Vice President

September 13, 1967

Mr. Edward M. Penick, President
Worthen Bank & Trust Company
P. O. Box 1681
Little Rock, Arkansas 72203

Dear Mr. Penick:

This refers to your letters of September 1 and September 12, 1967 seeking approval of your plans for the construction of a new bank building. We also acknowledge receipt of copy of letter dated September 1 to Mr. H. C. Adams, State Bank Commissioner, seeking his approval.

It is understood that the original proposal, outlined in your letter of August 26, has been abandoned.

As we understand it, the bank and office building is to be constructed and owned by a non-affiliated corporation and leased to the bank at an annual rental cost of approximately $584,250. The lease would be on a long-term basis with an option to purchase the building after fifteen years at an agreed upon figure. The cost of construction is estimated at $6,532,650 which together with the land cost of $965,000 would make a total investment by the owner of $7,497,650. It is understood that the bank will have no financial interest in the building and will furnish none of the funds for its construction.

It is further understood that the bank will construct a parking garage at an estimated cost of $1,001,350 on land

purchased for $460,000 for a total cost of $1,461,350. This investment when added to the present carrying value of leasehold improvements, present bank premises and preliminary cost of new bank building in the total amount of $1,695,768 would result in a total investment of $3,157,118 in bank premises by the bank, exclusive of furniture, fixtures and equipment now carried on the bank's books at $137,326 and $546,000 estimated cost of additional investment in such assets. We understand that the investment in bank premises of $3,157,118 is to be reduced from sale of present bank building estimated at $600,000 which would reduce the bank's total investment in bank premises to $2,557,118 which combined with investment in furniture, fixtures and equipment of $683,326 would result in a total investment in fixed assets of $3,240,444.

Since the total investment in bank premises would not exceed the bank's capital stock of $4,000,000, the approval of the Board of Governors, pursuant to the provisions of Section 24A of the Federal Reserve Act, is not required and this office will interpose no objection to the expenditure. However, the additional investment in fixed assets adds considerable pressure to a capital account that is not relatively strong and the directors are urged to review the bank's capital position frequently, to continue to conserve earnings in order that the capital structure may be strengthened and to provide additional capital funds upon completion of the building program should a review at that time warrant such action.

Very truly yours,

/s/ O. O. WYRICK
O. O. Wyrick
Vice President

P. Ex. 5

WORTHEN BANK AND TRUST COMPANY
ESTABLISHED 1877

LITTLE ROCK, ARKANSAS

September 1, 1967

Mr. H. C. Adams
State Bank Commissioner
National Old Line Building
Little Rock, Arkansas

Dear Mr. Adams:

Previously I submitted to you a plan for financing our new building under which we had originally proposed to issue $4 million in debentures and handle the balance of the construction cost of $5 million on a real estate mortgage loan. Due to the statutory limitations on the rate of interest we can pay on the debentures, we have been unable to locate a purchaser of the debentures at an interest figure of 6% or less. Consequently, this plan of financing must be abandoned.

I would like your approval of a plan whereby we would carry on our bank books the cost of the new equipment and leasehold improvements amounting to $1,325,000 and the cost of the parking garage and land on which the parking garage will be situated amounting to $1,195,000, giving us a total new investment amounting to $2,520,000 in land, garage, and leasehold improvements. We would carry this on our books, which with the amount we have previously invested in this category, will give us a total investment of $4,353,000 in land, buildings, and leasehold improvements. This figure includes our present land and building at Fourth and Main Streets, which we plan to sell. It is presently carried on our books at $600,000. Upon the completion of the sale we would then have in this category on the balance sheet $3,753,000, which is 32.6% of our capital, surplus, undivided profits, and reserves. I am enclosing a pro forma statement of this bank as of June 30, 1967, giving affect to this additional investment.

The balance of the cost of construction of our building amounting to approximately $6 million plus $965,000 on the land would be handled on a sale and leaseback basis, which would not exceed a maximum of $7½ million. We would have the right to repurchase this building after 15 years at a previously agreed upon figure and the land at the cost at which it was put in. We are in the process of negotiating with Goldman & Sachs Company of New York City the details of this sale and leaseback arrangement. I am enclosing a copy of a pro forma operating statement and projections for the next five years on the funds necessary for us to carry this sale and leaseback arrangement including the projected income we would receive from rents from this new bank building.

We realize that the sale and leaseback arrangement may be slightly more expensive in the long run. However, we are of the opinion that the advantages it offers us by not tying down our capital in land and building leaves us more leeway in the management of our bank and keeping our funds more profitably employed.

Previously I furnished you background information on the history of the bank and general economic conditions in our city and this same information would suffice for our request at this time for your approval of this plan of financing our new building.

I will be most happy to furnish you any other information you may need, as we are most anxious to start construction as quickly as possible.

Very truly yours,

President

EMP/mab

Enc. (1) Total Project Cost
(2) Pro Forma Balance Sheet as of 6/30/69
(3) Bank Building Pro Forma Operating Statement —1973
(4) Pro Forma Operating Statement 1968-1973

WORTHEN BANK AND TRUST COMPANY

TOTAL PROJECT COST

Cost of Bank Office Building & Land—Financed by Sale-Leaseback

Construction Cost	
Bank & Office Building—	
296,623 gross sq. ft. @ 20.23	6,000,000
Land	
41,050 sq. ft. @ 23.53 per sq. ft.	965,000
Estimated Cost of Bank, Office Building & Land	$6,965,000

Investment in Parking Garage, Furniture & Fixtures & Leasehold Improvements (June 30, 1967)

Leasehold Improvement	462,990
Bank Premises (Land & Building)	1,144,037
Furniture, Fixtures & Equipment	137,326
Preliminary Cost of New Bank Building (architects fees, consultants)	88,741
Total Present Investment	1,833,094
Sale of Present Building	—600,000 (1)
Total Investment in Bank & Premises	1,233,094

Additional Items to Be Included in Bank's Assets

Land (parking garage)		
19,600 @ 23.53 per sq. ft.		460,000
Parking Garage		
122,500 sq. ft. @ 6.00 per sq. ft.		735,000
Additional Investment in Furniture, Fixtures & Equipment		
Vault Equipment	32,000	
Under Counter Equip.	12,000	
Pneumatic Equip.	10,000	
T.V. Teller	125,000	
Kitchen-dining Equip.	150,000	
Carpeting	42,000	
Drapes	20,000	
Built-ins	75,000	
Furniture	80,000	546,000
Leasehold improvements		
Architects Fee	259,000	
Financing Charges	378,000	
Consultants Fee	162,000	779,000
Total Balance Sheet Investment in Bank & Premises		3,753,094 (2)

(1) Present bank building sold at book value of $600,000.00.
(2) Additional Investment in Leasehold Improvement since 6/30/67 estimated at $300,000.00.

Enclosure 1

WORTHEN BANK AND TRUST COMPANY

PRO FORMA BALANCE SHEET

Adjusted to 6-30-67 • Balance Sheet as of 6-30-69
(0's omitted)

	6/30/67	Completion of bldg. 6/30/69
Cash	38,488	38,488
U. S. Government Obligations	13,703	13,703
Obligations U.S. Instrumentalities	1,119	1,119
State & Municipal Obligations	11,527	11,527
Loans & Discounts	87,538	87,538
Loans Guaranteed by CCC	6,440 (1)	4,520
Stock in Fed	270	270
Bank Bldg., Vault & Equipment	1,833	3,753
Cash Value Life Ins.—Officers	149	149
Other Resources	328	328
Total Resources	161,395	161,395
Capital Stock	4,000	4,000
Surplus	5,000	5,000
Undivided Profits & Reserves	2,496	2,496
Reserve for Unearned Interest	2,704	2,704
Deposits	147,195	147,195
Total Capital & Liabilities	161,395	161,395

(1) Decreased Commodity Credit Corp. loan by additional investment carried in Bank Bldg., Vault & Equipment.

Enclosure 2

Worthen Bank and Trust Company

Bank Building

Pro-Forma Operating Statement—1973

Income			
Tenant (1)—119,380 sq. ft. @ 4.75 per			567,055
Parking—122,500 sq. ft.			
312 x 1.00 x 20 days x 12 months			74,880
			641,935
Less: 15% vacancy factor tenant space			
119,380 x 15% x 4.75			85,058
Estimated Annual Income			556,877
Expenses			
Building operation			
119,380 sq. ft. @ 1.50		179,070	
Parking: 122,500 sq. ft. @ .12		14,700	
Real Estate Taxes (estimated)			
Land	19,760		
Building	90,500	110,260	304,030
Net Income			252,847
Less:			
Lease Payment to Investor			—584,250
Net Income (Loss)			—331,403
Net rental per ft. for bank to occupy new bldg. (114,549 sq. ft.) $2.893 per sq. ft.			
Cost to occupy new building			331,403
Cost to occupy present quarters			192,321
Net Increase in occupancy cost			139,082

(1) Bank to occupy 114,549 sq. ft. including all public areas and dining facilities.

Enclosure 3

Worthen Bank and Trust Company

Pro Forma Operating Statement 1968-1973

(Amount in Thousands)

	1968	1969	1970	1971	1972	1973
Operating Earnings	9,300	10,400	11,400	12,450	13,500	14,500
Operating Expenses	7,600	8,500	9,450	10,400	11,300	12,200
Profit before taxes & additional cost allocable to new building	1,700	1,900	1,950	2,050	2,200	2,300
Plus:						
Occupancy Expense old building		96(1)	192	192	192	192
	1,700	1,996	2,142	2,242	2,392	2,492
Less:						
Interium Financing Cost	200	178				
Lease payment		292(2)	584	584	584	584
	1,500	1,526	1,558	1,658	1,808	1,908
Plus:						
Income from Building		27(3)	110(4)	167(5)	224(6)	252(7)
Net before taxes	1,500	1,553	1,668	1,825	2,032	2,160
Taxes(8)	399	413	444	485	541	575
Net after taxes	1,101	1,140	1,224	1,340	1,491	1,585

(1) Assumes occupancy in new building for 6 months
(2) Assumes 6 month lease payment on new building
(3) Assumes 6 months operation of building with 50% vacancy factor on tenant space; full operation of parking facility.
(4) 40% vacancy factor on tenant space
(5) 30% vacancy factor on tenant space
(6) 20% vacancy factor on tenant space
(7) 15% vacancy factor on tenant space
(8) Taxes are computed at 26.6% of Net Profit before taxes

Enclosure 4

P. Ex. 6

ARKANSAS
STATE BANK DEPARTMENT

H. C. Adams
Commssioner

CITY OF LITTLE ROCK

September 5, 1967

Mr. Edward M. Penick, President
Worthen Bank and Trust Company
Little Rock, Arkansas

Dear Mr. Penick:

Receipt is hereby acknowledged of your letter of September 21, outlining plans and procedure in constructing new building on property recently purchased by your bank for this purpose.

I interpose no objections to the plans as proposed and you have this Department's approval with the understanding that investment in parking garage will be charged off and amortized over a twenty year period, and that other investments in furniture, fixtures and leasehold improvements will be charged off and amortized over a ten year period and that title will be vested in Worthen Bank and Trust Company subject to no liens. It is noted in your projection cost that in the end, the total cost of land, building and leasehold improvements will aggregate $4,353,000.00, and upon the sale of the present land and building that you own at 4th and Main Street which is carried at $600,000.00 and will reduce this category to $3,753,000.00.

Estimated cost for construction of bank office building is estimated at $6,976,000.00, and would not exceed maxi-

mum of $7,500,000.00 and would be handled on a sale and leaseback basis. This is agreeable with this Department with the understanding that you would have the right to repurchase this building after fifteen years at agreed upon figure and the land at the cost at which it was, not to exceed $965,000.00.

Very truly yours,

/s/ H. C. ADAMS
H. C. Adams
State Bank Commissioner

P. Ex. 7

September 12, 1967

Mr. H. C. Adams
State Bank Commissioner
National Old Line Insurance Building
Little Rock, Arkansas

Dear Mr. Adams:

Mr. Wyrick, vice president of the Federal Reserve Bank, called today and wanted us to revise the figures of our total project cost that we had previously furnished you.

He requested us to divide the items of architect fees, finance charges, and consultant fees into those parts chargeable to the bank-office building and those parts chargeable to the parking garage. We have done this and I am enclosing a breakdown showing this allocation of these fees which is different from that previously furnished you.

Mr. Wyrick also wanted assurances from us that we would not handle the construction of this building on our statement at anytime by using a direct interim financing plan. We have assured him that the owners-lessors of the land can finance the construction of the building themselves and we will only be obligated to pay the cost of carrying the funds used in this construction period.

I am enclosing a copy of my letter to Mr. Wyrick, which I thought you would like to have for your files. If you have any questions, please call me.

Very truly yours,

President

P. Ex. 8

ARKANSAS
STATE BANK DEPARTMENT

H. C. Adams
Commssioner

CITY OF LITTLE ROCK

September 13, 1967

Mr. Ed Penick, President
Worthen Bank & Trust Company
Little Rock, Arkansas

Dear Mr. Penick:

I have your letter of September 12 in which you request several changes be made in the project cost of parking garage, furniture and fixtures and leasehold improvements.

I have no objection to these changes and you are authorized to proceed in accordance with your title project cost as presented to me in your letter of September 12.

Kindest personal regards, I am

Yours very truly,

/s/ H. C. ADAMS,
H. C. Adams
State Bank Commissioner

P. Ex. 9

WORTHEN BANK AND TRUST COMPANY

SALE AND LEASEBACK

Outline of Proposed Principal Lease Terms

Property: An 18-story office tower rising out of a ground floor banking space with drive-in banking facilities, to be constructed on 41,050 square feet of land in downtown Little Rock, Arkansas.

Interim Lease Term: From date of closing until the earlier of (1) 10 months after completion of the building or (2) ————————, 1970, except as that date may be extended by the number of days delay in construction caused by strikes or other events of force majeure.

Primary Lease Term: 25 years from the end of the Interim Lease term; at the end of the Primary Lease Term the Bank either will exercise a 10-year renewal option or will make an offer, which may be rejected by the owner, to purchase the property for 20% of its original cost.

Renewals: After the ten year renewal term, the Bank will have eight consecutive 5-year renewal terms to provide for use and occupancy for up to 75 years.

Rent: A. During the Interim Lease Term, rent will commence on the completion date and will be payable quarterly in amounts equal to —% (the interest rate on the required financing) of the completed cost of the property.

B. During the Primary Lease Term, rent will be payable quarterly in arrears in an annual amount equal to —% of the cost (assuming land cost of $965,000, building cost of $6,535,000 and 6¾% interest rate on

the required borrowing, rent will be 7.619%, or $571,430 annually).

Renewal Rents: Rent during the renewal terms will be as follows:

Years of Occupancy	*Annual Rent as a % of Original Cost*
26-35	3.00%
36-40	2.25%
41-45	1.50%
46 and thereafter	1.00%

Completion Agreement: The Bank will complete the construction of the building so that the completion date will occur not later than ...., 1969, except as such date may be extended by the number of days of construction time lost because of strikes or other events of force majeure, the completion date shall not have occurred on or before ....., 1971, the Bank will offer to purchase the land and building. Such offer may be rejected, in which even the Primary Lease Term will commence on that date and the Lease will remain in force and effect.

Net Lease: The Bank will have the same responsibilities in regard to the property as if it had complete ownership. The Lease will be completely "net" in that the Bank will pay as additional rent all expenses in connection with the property including, without limitation, real estate taxes, assessments, insurance premiums, costs of operation, repair and maintenance, and other charges related to use or occupancy.

Use and Occupancy: The Bank will be permitted to use the Property for any lawful purpose and will maintain

the Property in good condition subject to normal wear and tear. It is anticipated that part of the office space will be subleased to others and, in addition, the Bank may assign the Lease or sublet the Property providing that no such assignment or sublease shall affect or reduce any of its obligations as Lessee.

Property Additions or Improvements: The Bank will have the right to make additions and improvements to the Property from time to time, which additions and improvements will become the property of the owner at the end of the lease period, if not removed prior thereto. If the amount of such additions or improvements to the Property exceeds $..... during any two-year period, the Bank may request the owner to pay for these and owner will agree to do so. In the event that the owner pays for any such additions or improvements, rent will be increased to amortize the cost with interest over the remaining lease term. The interest cost will be then-current rates, as agreed upon by the Bank and the owner, and the owner will agree to accept or equal any interest cost which may be arranged by or offered through the efforts of the Bank.

Economic Abandonment: If, at any time after the end of the tenth year of the Primary Lease Term, in the opinion of the Bank, the Property no longer is suitable or economic for use in its operations, the Bank may terminate the Lease. The notice of termination must be accompanied by an offer to purchase the Property for an amount approximately equal to the remaining unamortized cost. The owner may reject that offer. If it is accepted, the Bank must purchase the property but must discontinue use thereof and make appropriate provisions for its disposition.

Condemnation or Casualty: In the event of a condemnation or a casualty, the Bank will restore or repair the property and will continue rental payments unabated

and the Bank will receive the condemnation award or the insurance proceeds; provided, however, that in the event of a condemnation or casualty of such nature that the Property no longer is usable by the Bank as determined by its Board of Directors, the Lease can be terminated. Notice of termination must be accompanied by an offer to purchase the Property for an amount approximately equal to the remaining amortized cost. This offer may be rejected. If accepted, the Bank will receive the condemnation award or insurance proceeds.

Purchase Options: The Bank will have options to purchase the property as follows:

End of Year	*Purchase Option as % of Original Cost*
15	72%
20	63%

(These amounts are based on an assumed land cost of $965,000 and building cost of $6,535,000.) In addition, the Bank will have an option to purchase the property at the end of the Primary Lease Term for an amount equal to the greater of fair market value or 20% of the original cost of the property. Thereafter the Bank will have options to purchase the property at fair market value at the end of each renewal period.

Investment Tax Credit: Any investment tax credit will be passed through to the Bank.

GOLDMAN, SACHS & Co.

P. Ex. 10

WORTHEN BANK AND TRUST COMPANY

PROPOSED FINANCING

Submitted By: Stephens, Inc.

Revised: October 27, 1967

General Description: The proposed method to be used to finance the Bank's new building is a sale-leaseback of the building.

Amount of Financing: The sale-leaseback financing proposed will provide $7,500,000.

Cost of Financing: Stand-by fees, legal, printing, and other direct costs of financing to be absorbed by the Bank.

Lease Provisions: In general, there will be a complete "net" lease.

Interim Term: With First National City as negotiated at cost.

Primary Term: 25 Years beginning at the end of the interim lease term.

Renewal Options: Eight 5-year renewal options with rent at 4% of original loan ($7,500,000) or $300,000 per year.

Annual Rental: The annual rent during the primary lease term will be $583,000 payable quarterly for the first 11 years of the lease, and beginning the 12th year rent will be $612,750.00.

Land: All land owned by Worthen Bank "involved in the new building project" will be leased to the Corporation "owning" the building for a period of 80 years.

Sales Taxes and Investment Credit: All savings on State Sales Taxes and all investment credit will be passed on to Worthen Bank.

Stand-By Fee: None.

Commitment Fee: 1%—Bank can escrow Government Bonds and receive income from the bonds during the interim period. At closing of permanent loan, the escrow account will be liquidated and the bonds returned to Worthen Bank.

Purchase Options: The Bank will receive options to repurchase the building at the end of the 11th, 15th, 20th, and 25th year as shown:

YEAR OF OPTION	MORTGAGE BALANCE	PURCHASE PRICE*
11th	$5,517,275.75	$6,225,000
15th	$4,426,274.78	$5,325,000
20th	$2,580,069.43	$3,800,000
25th	—0—	$2,850,000

* The above purchase price assumes that Worthen Bank will continue the mortgage loan with New York Life for the balance of the term of the loan, and the Bank assumes any penalty imposed by the lender for prepayment of the balance of the loan.

Summary of Redemption Restrictions and Prepayment Penalties By New York Life: Non-refundable for eleven (11) years from funds borrowed at lower interest rate. Refundable beginning the 11th year at 103, decreasing ¼ of 1% per year to 101 and remaining at 101 for the balance of the term of the loan. Refundable after the 11th year at 101 from excess earnings by Worthen Bank.

All terms and conditions outlined above are subject to our ability to borrow the necessary funds from New York Life.

P. Ex. 11

FRANK LYON COMPANY

October 30, 1967

Mr. Ed Penick, President
Worthen Bank & Trust Company
401 Main Street
Little Rock, Arkansas 72201

Dear Ed:

In our prior conversations, I have stated a definite interest in Frank Lyon Company's owning the new Worthen Building. We propose to purchase the building from you for $7,500,000 under a sale and lease back agreement and to borrow the money from New York Life Insurance Company on a note secured by a first mortgage on the building, a conditional assignment of your lease, and the general credit of Frank Lyon Company. The lease will require you to pay all expenses necessary to operate and maintain the building, including all repairs, all taxes, and the required insurance.

The annual rental payments will be $50,000 less than the amount of the mortgage payments for the first ten years, will be equal to our mortgage payments for the duration of the original mortgage, and will be $600,000 per year for the remainder of the lease. Worthen will have the option to purchase the building after fifteen years for $1,700,000 cash plus the assumption of the original mortgage. Worthen will also have options to re-purchase the building after twenty, twenty-five, thirty, thirty-five and forty years on a basis acceptable to Worthen Bank.

This letter merely outlines our proposal. We are flexible and want to negotiate an arrangement which is fair and equitable to both parties.

Sincerely,

FRANK LYON COMPANY
/s/ FRANK LYON
Frank Lyon
Chairman of the Board

P. Ex. 12

Comparison of Financing Plans

Sale-Leaseback $7,500,000.00 25 Years

	Frank Lyon $714,000— deferred 11 yrs.	Stephens firm $682,584— deferred 11 yrs.	Goldman Sachs tentative
Annual Lease Rentals	532,332.00 613,157.28	583,000 (11 yrs) 612,750 (12-25 yrs.)	571,430
Maturity Basic Lease	25 yrs	25 yrs	25 yrs
Percentage Mortgage Retire	100%	100%	100%
Renewal Options:			
1. 5 years	8%	4%	3%
2. 5 years	8%	4%	3%
3. 5 years	8%	4%	2.25%
4. 5 years	8%	4%	1.50%
5. 20 years	8%	4%	1.00%
Interim Cost Estimate	334,000	334,000	400,000
Fees	same	same	same
Repurchase:			
11th year		6,225,000	
15th year	6,152,903.62	5,325,000	5,400,000
20th year		3,800,000	4,725,000
25th year		2,850,000	
Total amount paid on basic rent @ 15th year	8,308,281.12	8,864,000	8,571,450
Cost of funds			
TOTAL @ 15th year:			
Basic Rent	8,308,281.12	8,864,000	8,571,450
Repurchase	6,152,903.62	5,325,000	5,400,000
	14,461,184.74	14,189,000	13,971,450

P. Ex. 13

October 31, 1967

Specification For Sale-Leaseback of Worthen Bank and Office Building

Sale will include office building and banking quarters, exclusive of building site and parking deck for $7,500,000.

The investor will submit offer based on loan to be made by New York Life Insurance Company @ 6¾% to be fully repaid in 25 years. Payments on this loan are to amortize 90% of the loan over 25 years for the first 11 years and 100% of the balance over the remaining 14 years, with payments being made quarterly in arrears. Worthen will have option to purchase at end of 11th, 15th, 20th, and 25th year.

Worthen will execute a net lease for entire building from investor and lease land to investor for the required term. Land and parking deck will be subordinated to loan of New York Life Insurance Company.

All investment tax credit and sales tax savings will accrue to Worthen Bank.

Worthen Bank reserves the right to approve any subsequent purchaser and to cancel ground lease upon its election to terminate lease after basic lease term or renewal lease term. In lieu of cancellation, adequate ground rental shall be provided for lease of land after basic lease term. Worthen's lease will be for a basic term of 25 years with 8, 5-year renewal options.

Worthen Bank will pay agreed commitment fee, attorney fees and printing costs.

Interim financing during construction is to be supplied by the First National City Bank of New York at the prime

rate of interest, such interest to be paid by Worthen Bank on amounts actually disbursed.

Investors interested in the above described sale and lease-back will supply the following information:

1. Equity to be supplied by investor $500,000 and annual rate of interest to be charged thereon 6%.
2. *Lease rental payments to be required per annum payable quarterly:*
   (a) 1 through 11 years $ 571,010
   (b) 11 through 25 years $ 601,476
3. Rate of lease payments for each 5 year renewal option. Dollar amount $300,000.
4. *Lease rental payments to be paid on land to Worthen Bank during each renewal 5 year term:*

   25 through 30 years $100,000
   30 through 35 years $150,000
   35 through 40 years $200,000
   40 through 45 years $250,000
   45 through 50 years $250,000
   50 through 55 years $250,000
   55 through 60 years $250,000
   60 through 65 years $250,000

5. *Options of Worthen Bank to repurchase subject to assumption of mortgage loan by Worthen:*

   11th year $822,362 (949,150—126,788)
   15th year $1,000,000 (1,198,280—198,280)
   20th year $1,603,568
   25th year $2,145,935

6. *Repurchase at 15th year—Summary:*

(a) Total rental payments at end 15th year	$ 8,687,014
(b) Total of equity and accrued interest at end 15th yr	$ 1,198,280
(c) Add any premium or deduct any discount ±	$ –198,280
(d) Total cost of sale leaseback including balance due on mortgage*.	$14,038,230

*Mortgage balance end of 15th year $4,351,216

These figures may not be entirely accurate since tables used were carried to only two places; minor differences will therefore obtain.

P. Ex. 14

FRANK LYON COMPANY

November 1, 1967

Mr. Ed Penick, President
Worthen Bank & Trust Company
401 Main Street
Little Rock, Arkansas 72201

Dear Ed:

We have reviewed your proposal submitted to us yesterday. Unequivocably, we would like to accept it.

However, we do not feel that this proposal is the best for Worthen Bank, therefore, we accept your proposal with one major change. Your lease payments for the first five years will be reduced by $21,000 annually. On the enclosed sheet we have listed the points contained in your specification for easy comparison of our amended proposal with your proposal.

Ed, as you know already, we want very much to be of service to Worthen Bank.

Yours truly,

FRANK LYON COMPANY
/s/ FRANK LYON
Frank Lyon
Chairman of the Board

SPECIFICATION FOR SALE-LEASEBACK OF WORTHEN BANK AND OFFICE BUILDING

1. Equity to be supplied by investor $500,000 and annual rate of interest to be charged thereon 6%.
2. *Lease rental payments to be required per annum payable quarterly:*

(a) 1 through 5 years	$550,000
(b) 6 through 11 years	$570,000
(c) 12 through 15 years	$600,000
(d) 16 through 25 years	$601,500

3. Rate of lease payments for each 5 year renewal option. Dollar amount $300,000.
4. *Lease rental payments to be paid on land to Worthen Bank during each renewal 5 year term:*

25 through 30 years	$100,000
30 through 35 years	$150,000
35 through 40 years	$200,000
40 through 45 years	$250,000
45 through 50 years	$250,000
50 through 55 years	$250,000
55 through 60 years	$250,000
60 through 65 years	$250,000

5. *Options of Worthen Bank to repurchase subject to assumption of mortgage loan by Worthen:*

11th year	$800,000	(949,150—149,150)
15th year	$1,000,000	(1,198,280—198,280)

20th year $1,603,568

25th year $2,145,935

6. *Repurchase at 11th year—Summary:*

(a) Total rental payments at end 11th year	$ 6,170,000
(b) Total of equity and accrued interest at end 11th year	949,150
(c) Add any premium or deduct any (discount)	(149,150)
(d) Balance of mortgage assumed	5,419,774
(e) Total cost of sale-leaseback	$12,389,774

P. Ex. 15

COMPARISON OF FINANCE PLANS

11/12/67

	Lyons(2)	*Ours*	*Lyons*(1)	*Stephens*
Lease Rentals:				
5 years	550,000	571,010	532,332	583,000
6 years	570,000	571,010	532,332	583,000
4 years	600,000	601,476	613,157	612,750
10 years	601,500	601,476	613,157	612,750
Investor Equity	500,000	500,000	860,000	360,000
Rate	6%	6%	6¾%	6%
Maturity Basic Lease	25 yrs.	25 yrs.	25 yrs.	25 yrs.
Renewal Options (40 years)	4%	4%	8%	4%
Land Rental to Worthen after 25 years:				
25 - 30 yrs.	100,000	100,000	0	0
30 - 35 yrs.	150,000	150,000	0	0
35 - 40 yrs.	200,000	200,000	0	0
40 - 65 yrs.	250,000	250,000	0	0
Fees	Same	Same	Same	Same
Interim Finance Cost:	334,000	334,000	334,000	334,000
Repurchase Options:				
11th year	800,000	822,362	—	707,724
15th year	1,000,000	1,000,000	1,700,000	898,725
20th year	1,603,568	1,603,568	—	1,219,930
25th year	2,145,935	2,145,935	—	2,850,000
Total @ 15th year:				
Basic Rent	8,570,000	8,687,014	8,308,281	8,864,000
Repurchase	5,351,216	5,351,216	6,152,903	5,325,000
Cost of Funds	$13,921,216	$14,038,230	$14,461,184	$14,189,000

P. Ex. 16

FIRST NATIONAL CITY BANK

Alan W. Peters
Vice President

November 30, 1967

Mr. Edward M. Penick
President
Worthen Bank and Trust Company
P.O. Box 1681
Little Rock, Ark. 72203

Dear Ed:

It is a pleasure to confirm the understanding worked out over the past few weeks regarding construction financing for your new building. We stand ready to lend up to $7,000,000 at our best commercial rate (fluctuating) to a mutually acceptable real estate corporation. We understand that there is a firm New York Life commitment for this amount and that Worthen Bank will guarantee completion of the building and minimum rentals required by the takeout.

Since Worthen Bank will not actually be guaranteeing our loan, we feel it reasonable to have some protection in the unlikely event that the New York Life loan does not become operative. May we suggest the best way to cover this eventuality is for Worthen to provide FNCB with a guarantee of rentals adequate to amortize the construction loan on a 20-year level payment schedule at 1½% above our then existing Best Rate.

With a real estate company as the actual borrower, we trust you agree with our feeling that this financing should be structured in the standard construction loan pattern. I suggest that our Mortgage & Real Estate Department people contact Dick Gates or one of your other officers to

work out mechanics of the many details such as review of the takeout, handling of the mortgage, certification of the draws, and so forth.

I trust that the arrangements outlined above are completely agreeable to everyone at Worthen Bank. If so, let's move forward as quickly as possible to put the details in order. We are anxious to cooperate and certainly do not want the first draw to be delayed by any technical problem.

Best regards,

Sincerely,

Al

P. Ex. 17

NEW YORK LIFE INSURANCE COMPANY

Richard W. Baker, Jr., Vice President
in Charge of Real Estate and Mortgage Loans

December 18, 1967

Frank Lyon Company
P.O. Box 4408
Little Rock, Arkansas

Gentlemen:

You have advised us as follows with respect to the Worthen Building, which is being constructed in Little Rock, Arkansas, and with respect to the financing program for this property:

(1) Worthen Bank and Trust Company (the "Bank") owns a parcel of land (the "Land") located at 200 West Central Capitol Avenue, Little Rock, Arkansas, and having an area of approximately 61,720 square feet, upon which the Bank is constructing the Worthen Building and a separate parking facility (the "Parking Facility") to provide parking for about 387 automobiles. The Worthen Building will be a 24-story and single basement, centrally air-conditioned, steel, concrete and masonry bank and office building, with 6 elevators and about 217,860 square feet of net rentable space. It is expected that construction will be completed by July, 1969.

(2) The Bank's estimated costs total $10,304,000, being $964,198 for acquisition of the site of the Worthen Building, $460,802 for acquisition of the site of the Parking Facility, $6,463,000 for construction of the Worthen Building, $1,015,000 for construction of the Parking Facility, $857,000 for consultant's and architect's fees and financing charges and $544,000 for fixtures and equipment.

(3) Upon the completion of construction, the Bank, as lessor, and a wholly-owned real estate subsidiary (the "Company") of Frank Lyon Company, as lessee, will enter into a lease (the "Ground Lease") of the land underlying the Worthen Building for an initial term of 25 years at a nominal ground rent, with renewals for an additional 40 years. At the same time, the Company will purchase the Worthen Building and possibly certain fixtures and equipment (the "Personal Property") from the Bank for $7,640,000, which amount will not exceed those costs to the Bank of construction of the Worthen Building and of the Personal Property which are properly capitalizable in accordance with sound accounting practice, as such costs shall have been verified by us and to our satisfaction.

(4) The purchase of the Worthen Building and the Personal Property by the Company is to be financed by a corporate loan in the principal amount of $7,140,000 to be made to the Company at the time of such purchase, which loan will be evidenced by the 6¾% secured note (the "Note") of the Company secured by an assignment to us of a lease (the "Sublease") of the Worthen Building, the lessee's interest in the Ground Lease and the Personal Property between the Company, as landlord, and the Bank, as tenant. The Note is to be additionally secured by a deed of trust (the "Deed of Trust") constituting a first lien on the Land, the Worthen Building, the Parking Facility and the leasehold estate created by the Ground Lease and a chattel mortgage or other effective first lien on the Personal Property. The Deed of Trust will include, among other provisions, provisions requiring continuance of the corporate existence of the Company until full payment of the Note.

(5) The Note will be fully repaid over the period of 25 years by constant quarterly payments of $145,581.03 during the first 11 years of such period and of $153,289.32

during the remaining 14 years of such period, all such payments to be applied first to interest at the rate of 6¾% per annum and the balance to principal.

(6) The Sublease shall be an absolutely net lease, shall permit no abatement or reduction of rent except upon conditions acceptable to us and shall be non-cancellable except upon such conditions as shall assure payment of the Note in full. If, and to the extent that, we so elect, the Deed of Trust shall be subordinate to the Sublease. The fixed expiration date of the Sublease shall in no event be earlier than the final maturity date of the Note. The Sublease shall provide for the payment of net rent in quarterly installments in amounts at least equal to the amounts of the quarterly payments required to be made by the Company pursuant to the terms of the Note, as above provided.

(7) The value of the Land, as determined by our appraisers, shall not be less than $1,425,000. Those costs to the Bank of acquisition of the Land and of construction of the Worthen Building and the Parking Facility (including consultant's and architect's fees and financing charges) which are properly capitalizable in accordance with sound accounting practice, as such costs shall have been verified to our satisfaction by a firm of independent certified public accountants satisfactory to us, shall be not less than $9,500,000.

(8) All costs and expenses in connection with the proposed transaction, including, without limitation, the cost of title insurance, survey charges, the fees and disbursements of our special counsel, recording fees, documentary stamp and other taxes and printing expenses will be paid by you or the Company.

We are pleased to advise you that, on the basis of the foregoing, and subject to our approval of the plans and specifications of the Worthen Building and the Parking

Facility, the title to the properties (including any easements affecting the Land), all proceedings to be taken in connection with the loan herein contemplated and the form and substance of all documents incident thereto, including, without limitation, the Note, the Deed of Trust, the Ground Lease, the Sublease and the instrument assigning to us all of the lessor's interest in the Sublease, and subject further to the several matters referred to or set forth in this letter or in the Summary of Certain Principal Terms and Conditions (the "Summary") attached hereto as Exhibit A, we will agree that, upon the performance of all of the terms and conditions referred to or set forth in this letter or in the Summary, we will purchase the Note in the principal amount of $7,140,000.

It is understood that our agreement to purchase the Note will be contained in a separate Note Agreement between the Company and us, setting forth all of the terms and conditions of the loan and in form and substance satisfactory to the Company and to us (and including, as exhibits thereto, the forms of the Ground Lease, the Sublease, the Deed of Trust and other appropriate documents), and that the Note Agreement will be entered into as soon as practicable.

We shall expect you to pay or reimburse us for, and by your confirmation of this letter you agree to reimburse us for, the fees and disbursements of our special counsel and all other out-of-pocket expenses which may be paid or incurred by us in connection with the proposed loan even if, for any reason whatsoever, the Note Agreement is not executed or, if executed, the transaction is not consummated.

By your confirmation of this letter, you further agree to indemnify and hold us harmless against any claim for brokerage commission or other such compensation which may be made against us by any person, firm or corpora-

tion in connection with the transaction contemplated herein.

If the foregoing is satisfactory to you, please so confirm by signing the enclosed copy of this letter and returning it to me within 15 days of the date of this letter.

Very truly yours,

NEW YORK LIFE INSURANCE COMPANY
By /s/ RICHARD W. BAKER, JR.
Vice President in Charge
of Real Estate and Mortgage Loans

Confirmed as of the date first above written.

FRANK LYON COMPANY
By /s/ FRANK LYON
President

EXHIBIT A

6¾% Secured Note
of
Wholly-Owned Subsidiary of
FRANK LYON COMPANY

SUMMARY OF CERTAIN PRINCIPAL TERMS AND CONDITIONS

Issuer: Wholly-owned subsidiary of Frank Lyon Company.

Amount of Note: $7,140,000.

Rate: 6¾%.

Maturity: 25 years from date of Note.

Date of Closing: August, 1969.

Mandatory Payments: Constant quarterly payments of $145,581.03 during the first 11 years and of $153,289.32 during the remaining 14 years prior to maturity, all such payments to be applied first to interest at the rate of 6¾% per annum and the balance to principal.

Optional Prepayments: No privilege to prepay prior to the end of the 11th loan year. Privilege to prepay the Note in full at the end of the 11th loan year and thereafter at a premium starting at 3½% at the end of the 11th loan year and decreasing ¼ of 1% per year to the end of the 21st loan year and at a premium of 1% thereafter.

Security: First deed of trust on the fee title of the Bank to the Land and the Parking Facility, on the fee title of the Company to the Worthen Building and on the leasehold estate of the Company under the Ground Lease and first chattel mortgage or other effective first lien on the Personal Property, subject only to the Ground Lease, the Sublease, the assignment of all of

the lessor's right, title and interest in the Sublease and such other matters as New York Life may approve.

Title Evidence: Title insurance to be furnished with respect to liens on real property in the amount of $7,140,000 by title insurance companies, and pursuant to policies, in form, substance and amount, satisfactory to New York Life. Attorney's opinion to be furnished with respect to lien on fixtures and equipment by counsel, and pursuant to opinion in form and substance, satisfactory to New York Life.

Sublease: The lessee's interest under the Ground Lease and all real property, fixtures and equipment acquired by the Company to be leased by the Company to the Bank. The Sublease to be an absolutely net, noncancellable lease for a term of at least 25 years from the date of the Note and to provide for net rent payable in quarterly installments at least equal to the amounts of the quarterly mandatory payments required by the Note. The Sublease to provide for furnishing of financial, operating and other statements by the Bank.

Assignment of Sublease: The Company's unencumbered right, title and interest in the Sublease to be assigned to New York Life to secure payment of the Note.

Insurance: The Bank to maintain public liability, fire and extended coverage and boiler insurance and war damage insurance when a state of war or public emergency exists and, as required by New York Life, other insurance when customarily carried by prudent owners of comparable properties.

Deed of Trust Provisions: Deed of Trust to include, among other provisions, provisions satisfactory to New York Life relative to compliance with the terms of the Ground Lease and the Sublease, continuance of the corporate existence of the Company until full payment of the Note and furnishing of financial and other

statements, and prohibiting the Company from engaging in any business other than owning, holding, leasing, maintaining and operating real property and fixtures and equipment incident thereto and from transferring the security except to an assuming domestic corporation.

Escrow: If, on the date of closing, more than 15% of the net rentable space in the Worthen Building is unfinished for occupancy, $5.00 per square foot of such unfinished space will be deposited by the Company in escrow upon terms and conditions satisfactory to New York Life until no more than 15% of such space remains unfinished.

Expenses: All expenses incident to the transaction, including, without limitation, title insurance and survey charges, fees and disbursements of New York Life's special counsel, recording fees, documentary stamp and other taxes and printing expenses are to be paid by you.

Note Agreement: Agreement to be entered into between the Company and New York Life with respect to the issuance and purchase of the Note as soon as practicable containing representations and warranties and other provisions satisfactory to New York Life including, among other provisions, provisions satisfactory to New York Life relative to closing conditions and indemnification with respect to brokerage and other commissions, if any.

P. Ex. 18

Exhibit D

WORTHEN BANK & TRUST COMPANY, *Lessor*

and

FRANK LYON COMPANY, *Lessee*

Ground Lease

Dated as of May 1, 1968

GROUND LEASE

This Lease is dated as of May 1, 1968, between Worthen Bank & Trust Company (the "Bank"), an Arkansas banking corporation with its principal office and place of business at Fourth and Main Streets, Little Rock, Arkansas, and Frank Lyon Company (the "Company"), an Arkansas corporation with its principal office and place of business at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas.

1. *Leased Property.* Upon and subject to the conditions and limitations set forth herein, the Bank leases to the Company, and the Company rents from the Bank, the real property (called "Tract A") described in Schedule 1 hereto.

2. *Term of Lease.* Subject to the further provisions hereof, this lease shall remain in full force and effect for a term commencing on May 1, 1968, and expiring at mid-

night on November 30, 2044*, unless the lease shall sooner terminate as provided in Paragraph 9 hereof.

3. *Rent.* The Company will pay to the Bank rent as follows:

(a) For the entire period commencing May 1, 1968, and ending November 30, 1994, the rent shall be the sum of $50.00, payable upon the execution of this Ground Lease, receipt of which is hereby acknowledged.

(b) For the period commencing December 1, 1994, and ending November 30, 1999, an annual rent of $100,000 per year and one-fourth thereof shall be paid on the last day of each February, May, August and November during each year of such period.

(c) For the period commencing December 1, 1999, and ending November 30, 2004, an annual rent of $150,000 per year and one-fourth thereof shall be paid on the last day of each February, May, August and November during each year of such period.

(d) For the period commencing December 1, 2004, and ending November 30, 2009, an annual rent of $200,000 per year and one-fourth thereof shall be paid on the last day of each February, May, August and November during each year of such period.

(e) For the period commencing December 1, 2009, and ending November 30, 2014, an annual rent of $250,000 per year and one-fourth thereof shall be paid on the last day of each February, May, August and November during each year of such period.

(f) For the period commencing December 1, 2014, and ending November 30, 2034, an annual rent of

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* All dates contained herein, other than May 1, 1968, shall be changed accordingly if the closing date in the Note Purchase Agreement shall be other than December 1, 1969.

$250,000 per year and one-fourth thereof shall be paid on the last day of each February, May, August and November during each year of such period.

(g) For the period commencing December 1, 2034, and ending November 30, 2044, an annual rent of $10,000 per year and one-fourth thereof shall be paid on the last day of each February, May, August and November during each year of such period.

4. *No Claims Against the Bank.* Nothing contained in this Ground Lease be construed as giving the Company any right, power or authority to contract for or permit the performance of any labor or services or the furnishing of any materials or other property in such fashion as would permit the making of any claim against the Bank in respect thereof.

5. *Indemnification by the Bank.* During the term of the Building Lease dated as of May 1, 1968, between the Bank and the Company, the Bank will protect, indemnify and save harmless the Company from and against all liabilities, obligations, claims, damages, penalties, causes of action, costs and expenses (including attorney's fees) imposed upon or incurred by or asserted against the Company in connection with this Ground Lease. If any action, suit or proceeding is brought against the Company by reason of any occurrence on or about Tract A during the term of said Building Lease, the Bank will at its expense resist and defend such action, suit or proceeding or cause the same to be resisted and defended by counsel designated by the Bank.

6. *Payment of Taxes.* The Bank (a) shall pay all taxes, assessments, water or sewer charges, license fee, inspection fees, and other governmental charges with respect to Tract A, and (b) shall have the right to contest the amount or validity of such charge if such proceedings shall operate

to prevent or stay the sale of Tract A to satisfy such charge.

7. *Insurance.* Any insurance with respect to Tract A shall be procured, maintained, and paid for by the Bank.

8. *Condemnation of Property.* In case of a taking of all or part of Tract A as a result of the exercise of the power of eminent domain, or the commencement of any proceedings or negotiations which might result in any such taking, the Company shall promptly give written notice thereof to the Bank, generally describing the nature and extent of such taking or the nature of such proceedings or negotiations and the nature and extent of the taking might result therefrom, as the case may be. In the absence of any judicial determination or allocation of values as between Tract A and the improvements thereon, any payment or award received by the Bank or by the Company shall be held in trust by the recipient pending a determination of the respective interests of the Bank and the Company therein. The Company irrevocably authorizes and empowers the Bank, in its name or otherwise, to file and prosecute what would be the Company's claim for any such award or payment and to collect, give a receipt for, and retain the same as herein provided. The Bank will pay all costs, fees and expenses reasonably incurred by the Company in connection with any such taking and seeking and obtaining any award or payment on account thereof.

9. *Termination.* This Ground Lease shall terminate (a) upon termination of the Building Lease dated as of May 1, 1968, between the Bank and the Company pursuant to Articles XVIII or XX thereof, or (b) upon the purchase by the Bank of the improvements on Tract A pursuant to Articles XVII or XVIII or said Building Lease.

10. *Mortgage or Assignment to Leasehold Mortgagee.* The Company shall have the authority, without the consent

or approval of the Bank, to mortgage is leasehold interest and to assign this Ground Lease and the leasehold estate created thereby (including, but not limited to, an assignment in lieu of a foreclosure) to a Leasehold Mortgagee. As used herein, the term "Leasehold Mortgagee" shall mean each person, firm, corporation, or other entity to which any part of the Company's leasehold under this lease or any other rights (beneficial or otherwise) of the Company under this lease shall at the time have been conveyed, conditionally or otherwise, by the Company under a mortgage or deed of trust. This Lease shall not be modified, altered, amended or terminated without the written consent of any such Leasehold Mortgagee.

11. *Default and Termination.* Commencing December 1, 1994, if the Company shall fail to pay any rent to the Bank when the same shall have become due and payable, and such failure shall continue for more than (30) days after receipt of written notice from the Bank, then the Bank at any time thereafter may at its option give a written termination notice to the Company, and upon the date specified in such notice the term of this lease shall expire and terminate, and all rights of the Company under this lease shall cease, subject to the following limitations:

(a) When giving notice to the Company with respect to any default under the provisions of this lease, the Bank shall also serve a copy of such notice upon any Leasehold Mortgagee by first class registered or certified mail, and no such notice to the Company shall be effective unless a copy of such notice is so served upon the Leasehold Mortgagee.

(b) If the Company shall fail to cure the default in the time prescribed herein, further notice to that effect shall likewise be given to the Leasehold Mortgagee by first class registered or certified mail.

(c) The Leasehold Mortgagee shall be allowed such additional time as may be required within which either to cure the default or to institute and complete foreclosure proceedings, or otherwise acquire title to the leasehold interest, and, so long as the Leasehold Mortgagee shall be engaged either in curing the default or in proceeding to foreclose the mortgage or deed of trust, no such default shall operate or permit the Bank to terminate the lease.

(d) If this lease should be terminated as provided herein, the Leasehold Mortgagee shall be entitled to receive a new lease for the remainder of the term upon the same terms and conditions as herein contained and having the same relative priority as the original lease if (i) the Leasehold Mortgagee agrees to take prompt steps to cure all defaults of the Company, (ii) the Leasehold Mortgagee makes a written request upon the Bank for such new lease within thirty (30) days from the date of termination of this lease, and (iii) such written request is accompanied by payment to the Bank of all amounts then due to the Bank.

(e) The Leasehold Mortgagee shall be granted the right to cure any default on the part of the Company and the further right to enter upon the premises and do all things necessary to that end.

12. *Liability of Leasehold Mortgagee.* The Leasehold Mortgagee shall not become personally liable for the obligations of this lease unless and until it becomes the owner of the leasehold estate by foreclosure, assignment in lieu of foreclosure or otherwise, and thereafter shall remain liable for such obligations only so long as the Leasehold Mortgagee remains the owner of the leasehold estate. If the Leasehold Mortgagee should become the owner of the leasehold estate, it may assign the lease without the Bank's consent, and any purchase money mortgage delivered in

connection with any such assignment shall be entitled to the benefit of all of the provisions of this lease with respect to the mortgage or deed of trust of the leasehold estate.

13. *No Waiver.* No failure by the Bank to insist upon the strict performance of any term hereof or to exercise any right, power or remedy consequent upon a breach hereof, and no acceptance of full or partial rent during the continuance of any such breach, shall constitute a waiver of any such breach or of any such term. No waiver of any breach shall affect or alter this lease, which shall continue in full force and effect, or the rights of the Bank with respect to any other then existing or subsequent breach.

14. *Notices.* All notices and other communications hereunder shall be in writing and shall be deemed to have been given when mailed by first class registered or certified mail, postage prepaid, addressed (a) if to the Bank, to Worthen Bank & Trust Company, at Fourth and Main Streets, Little Rock, Arkansas, or at such other address as the Bank shall have furnished to the Company in writing, or (b) if to the Company, at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas, to the attention of Mr. Ralph Cotham, or at such other address as the Company shall have furnished to the Bank in writing, or (c) if to any Leasehold Mortgagee, at such address as such Leasehold Mortgagee shall have furnished in writing to the Bank and the Company.

15. *No Merger of Title.* There shall be no merger of this lease or of the leasehold estate created by this lease with the fee estate in Tract A or any part thereof by reason of the fact that the same person, firm, corporation or other entity may acquire or own or hold, directly or indirectly, (a) this lease or the leasehold estate created by this lease or any interest in this lease or in any such leasehold estate

and (b) the fee estate in Tract A or in any part thereof or any interest in such fee estate. No such merger shall occur unless and until all persons, corporations, firms and other entities, including each Leasehold Mortgagee, having any interest in (i) this lease or the leasehold estate created by this lease and (ii) the fee estate in Tract A or any part thereof shall join in any written instrument effecting such merger and shall duly record the same.

16. *General.* Neither this lease nor any provision hereof may be changed, waived, discharged, or terminated orally, but only by an instrument in writing signed by the party against which enforcement of such change, waiver, discharge or termination is sought. All terms and provisions of this lease shall be binding upon and inure to the benefit of and be enforceable by the respective successors and assigns of the parties hereto. The paragraph headings in this lease are for purposes of reference only and shall not limit or define the meaning hereof. This lease may be executed in several counterparts, each of which is an original, but all of which shall constitute one instrument.

In Witness Whereof, the parties hereto have caused this lease to be executed and their respective corporate seals to be hereunto affixed and attested by their respective officers thereunto duly authorized.

Attest:
/s/ Booker Worthen
Secretary

Worthen Bank & Trust Company
By /s/ Edward M. Penick
President

Attest:
/s/ M. R. Godwin
Secretary

Frank Lyon Company
By /s/ C. W. Adams

(Acknowledgements Omitted in Printing)

SCHEDULE 1 OF GROUND LEASE

The land (Tract A) referred to in Paragraph 1 of the Ground Lease, dated as of May 1, 1968, between Worthen Bank & Trust Company, Lessor and Frank Lyon Company, Lessee, to which this Schedule 1 is attached, consists of a parcel in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

BEGINNING at the Southwest corner of Lot 6, Block 84, Original City of Little Rock; thence northerly 160.33 feet along the West side of Lots 6, 5, 4 and 3 to a point 139.67 feet South of the Northwest corner of said Block 84; thence easterly 140.0 feet to a point on the East side of Lot 3, located 139.67 feet South of the Northeast corner of Lot 1; thence 43.88 feet in a southerly direction along the East side of Lots 3 and 4; thence easterly 160.0 feet to a point on the East side of Lot 9, located 116.45 feet North of the Southeast corner of Lot 7; thence southerly 116.45 feet along the East side of Lots 9, 8 and 7 to the Southeast corner of Lot 7; thence westerly 300.0 feet along the South side of Lots 7 and 6 to the point of beginning,

SUBJECT, HOWEVER, to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of City of Little Rock, Arkansas, to Worthen Bank & Trust Company.

LESS AND EXCEPT

(a) the air space above the North 29.33 feet of Tract A beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied

by the elevator shaft and stair well on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

FURTHER SUBJECT to liens for unpaid taxes and assessments and to unfiled mechanics' and materialmens' liens.

P. Ex. 19

Exhibit E

FRANK LYON COMPANY, *Lessor*

AND

WORTHEN BANK & TRUST COMPANY, *Lessee*

Building Lease

Dated as of May 1, 1968

(Table of Contents Omitted in Printing)

BUILDING LEASE

LEASE, dated as of May 1, 1968, between Frank Lyon Company (Lessor''), an Arkansas corporation having its principal office and place of business at West 65th Street and Scott Hamilton Drive,, Little Rock, Arkansas, and Worthen Bank & Trust Company (''Lessee''), an Arkansas banking corporation having its principal office and place of business at Fourth and Main Streets, Little Rock, Arkansas.

ARTICLE 1

LEASED PROPERTY; INITIAL TERM OF LEASE

SECTION 1.1 Upon and subject to the conditions and limitations set forth herein, Lessor leases to Lessee, and Lessee rents from Lessor, the following properties (collectively, the ''Property''):

(a) All buildings, structures and other improvements now or hereafter located on the land (Tract A'') described in Schedule 1 hereto (collectively called the ''Improvements''); and

(b) All machinery and fixtures of every kind and nature whatsoever (collectively called the ''Building Service Equipment'') which may be used or procured for use in connection with the operation and maintenance of the Improvements, including but not limited to engines, motors, generators, dynamos, pumps and similar apparatus; furnaces, boilers, incinerators, oil burners, radiators and piping; stokers, heaters, tanks and heating equipment; wiring and electrical equipment; gas, electric, lighting, heating, plumbing, and bathroom fixtures, including pipes and conduits; elevators, escalators and lifting apparatus; refrigerating, air cooling, air conditioning, ventilating and sprinkling apparatus; partitions, built-in kitchen and restaurant equipment; plants and shrubbery; and wall-to-wall carpeting and all other equipment and furnishings used or procured for use in connection with the operation and maintenance of the Improvements, together with all replacements thereof and additions thereto, but specifically excluding safety deposit boxes, vault doors, banking trade fixtures, furniture, china, glassware, silverware and similar personalty; and,

(c) All of the leasehold estates, right, title and interest of Lessor created by that certain Ground Lease between Worthen Bank & Trust Company, as landlord, and Frank Lyon Company, as tenant, dated as of May 1, 1968, recorded in the office of the Circuit Clerk and Ex-Officio, Recorder of Pulaski County, Arkansas, on———, 1968, in Book—— at page——, in and to Tract A.

SECTION 1.2. Subject to the further provisions hereof, this Lease shall remain in full force and effect for an initial term (the ''Initial Term'') commencing on May 1, 1968, and expiring at midnight on November 30, 1994,* unless this Lease shall sooner terminate as hereinafter provided,

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* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

with privilege unto Lessee, its successor and assigns, to extend the term of this Lease as provided in Section 2.1.

ARTICLE II

Extended Term of Lease

Section 2.1. If Lessee is not in default in the performance of any of its obligations hereunder, it shall have the options to extend the term hereof successively for eight (8) additional terms of five (5) years each upon the same terms as herein contained except that the Basic Rent payable during each such extended term shall be as set forth in Section 3.1 (b) and the number of extended terms permitted hereunder shall be reduced by one upon each such extension. Lease shall exercise each such option by giving written notice of such exercise to Lessor not less than twelve (12) months prior to the expiration of the term or the extended term, as the case may be, then in effect. Should Lessee fail to exercise any option to extend the term hereof, it shall have no right thereafter to exercise any succeeding option to extend the term hereof.

ARTICLE III

Basic Rent

Section 3.1. Lessee will pay to Lessor or Assignee a net basic rent ("Basic Rent") as follows:

(a) For the portion of the Initial Term of this Lease prior to December 1, 1969,* no Basic Rent shall be payable, and for the balance of the Initial Term of this Lease a Basic Rent shall be payable as follows:

(1) For the period commencing December 1, 1969,* and ending November 30, 1980,* $145,581.03

* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

on each of the forty-four (44) Quarterly Installment Dates (as defined in Section 3.3 hereof) within such period.

(2) For the period commencing December 1, 1980,* and ending November 30, 1994,* $153,289.32 on each of the fifty-six (56) Quarterly Installment Dates within such period.

(b) For each five-year extended term, a Basic Rent at an annual rate of $300,000. Such Basic Rent shall be payable in equal quarterly installments on the Quarterly Installment Dates within each such extended term.

Section 3.2. The Basic Rent and other sums payable to Lessor or Assignee hereunder shall be payable in such coin or currency of the United States of America as at the time of payment shall be legal tender for the payment of public and private debts and shall be paid to Lessor or Assignee at Lessor's address set forth above or to such agent or person or persons or at such other address as Lessor or Assignee from time to time may designate in writing. The Basic Rent shall be absolutely net to Lessor or Assignee so that this Lease shall yield to Lessor or Assignee the full amount of the installments of Basic Rent throughout the term of this Lease without deduction.

Section 3.3. The Quarterly Installment Dates are the last day of each February, May, August and November during the term of this Lease or any extension thereof commencing February 28, 1970.*

* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

ARTICLE IV

Additional Rent

Section 4.1. Lessee will also pay, from time to time as provided in this Lease as additional rent ("Additional Rent"), (a) all other amounts, liabilities and obligations which Lessee herein assumes or agrees to pay, (b) interest at the rate of 10% per annum on such of the foregoing amounts, liabilities and obligations as are payable to Lessor or Assignee and are not paid when due, from the due date until payment thereof, and (c) interest at the rate of 10% per annum on all overdue installments of Basic Rent, from the due date thereof until payment. In the event of any failure on the part of Lessee to pay any Additional Rent, Lessor or Assignee shall have all the rights, powers and remedies provided for in this Lease or at law or in equity or otherwise in the case of non-payment of the Basic Rent.

ARTICLE V

No Counterclaim, Abatement, Etc.

Section 5.1. The Basic Rent, Additional Rent and all other sums payable by Lessee hereunder shall be paid without notice, demand, counterclaim, setoff, deduction or defense and without abatement, suspension, deferment, diminution or reduction, and the obligations and liabilities of Lessee hereunder shall in no way be released, discharged or otherwise affected (except as expressly provided herein) for any reason, including, without limitation, whether occurring before or after the Completion Date: (a) any defect in the condition, quality or fitness for use of the Property or any part thereof; (b) any change of grade of any abutting street; (c) any damage to or destruction of or any Taking (for a limited period or otherwise) of the Property or any part thereof; (d) any restriction, prevention or curtailment of or interference with any of the Property or any part thereof; (e) any title defect or encumbrance or any eviction or prospective eviction from the

Property or any part thereof by title paramount or otherwise; (f) any change, waiver, extension, indulgence or other action or omission in respect of any obligation or liability of Lessor; (g) any bankruptcy, insolvency, reorganization, composition, adjustment, dissolution, liquidation or other like proceeding relating to Lessor or Assignee, or any action taken with respect to this Lease by any trustee or receiver of Lessor or of Assignee, or by any court, in any such proceeding; (h) any claim which Lessee has or might have against Lessor or Assignee; (i) any failure on the part of Lessor to perform or comply with any of the terms hereof or of any other agreement with Lessee; or (j) any other occurrence whatsoever, whether similar or dissimilar to the foregoing; whether or not Lessee shall have notice of knowledge of any of the foregoing. Except as expressly provided herein, Lessee waives all rights now or hereafter conferred by statute or otherwise to quit, terminate or surrender this Lease or the Property or any part thereof, or to any abatement, suspension, deferment, diminution or reduction of Basic Rent, Additional Rent or any other sum payable by Lessee hereunder. All payments by Lessee to Lessor hereunder shall be final, and Lessee will not seek to recover any such payment or any part thereof for any reason whatsoever.

ARTICLE VI

Condition and Use of Property

Section 6.1. Lessor makes no representation or warranty with respect to the present or future condition of the Property or its fitness or availability for any particular use, and neither Lessor nor Assignee shall be liable for any latent or patent defect therein. Lessee may use the Property for any lawful purpose and will not do or permit any act or thing which is contrary to any Legal Requirement or Insurance Requirement, or which might impair the value or usefulness of the Property or any part

thereof, or which constitutes a public or private nuisance or abandonment or waste of the Property or any part thereof.

ARTICLE VII

Repairs and Maintenance of Premises

Section 7.1. Lessee convenants throughout the term of this Lease, at Lessee's sole cost and expense, to take good care of the Property and the adjoining sidewalks, curbs and vaults, and subject to the provisions of this Lease elsewhere set forth, to keep the same in good order and condition, excepting reasonable wear and tear, and promptly at Lessee's own cost and expense to make all necessary repairs, interior and exterior, structural and nonstructural, ordinary as well as extraordinary, foreseen as well as unforeseen, and to shore the foundations and walls of the Property, and to do any other acts necessary for the preservation and safety of the Property if an excavation or other building operation shall be made upon any adjoining premises or streets. When used in this Section, the term "repairs" shall include replacements or renewals when necessary, and all such repairs made by Lessee shall be at least equal in quality and class to the original work. Lessee shall keep and maintain all portions of the Property and the adjoining sidewaks in a clean and orderly condition, free of accumulation of dirt, rubbish, snow and ice.

ARTICLE VIII

Replacement and Removal of Building

Service Equipment

Section 8.1. All improvements and alterations to the Property, all replacements or renewals of Building Service Equipment, and all personal property and fixtures acquired or installed by or on behalf of Lessee pursuant to

Lessee's covenants in Section 7.1 hereof shall, immediately upon completion, acquisition or installation thereof, be and become the property of Lessor without payment therefor by Lessor and shall be surrendered to Lessor upon the expiration or earlier termination of the term of this Lease. Lessee shall be entitled to remove any of Lessee's personal property, as defined in ARTICLE XXXI hereof, during the term of this Lease, or if the term shall end prior to the date herein specifically fixed for such termination, then within a reasonable time thereafter, but Lessee shall, at its own cost and expense, repair any and all damage to the Property resulting from or caused by their removal therefrom.

ARTICLE IX

Public Utility Charges

Section 9.1. Lessee agrees to pay or cause to be paid all charges for gas, electricity, light, heat, power, water, storm and sanitary sewage, telephone and other communication service used, rendered or supplied upon or in connection with the Property throughout the term of this Lease, and to indemnify Lessor and save it harmless against any liability or damages on such account. Lessee shall also at its sole cost and expense procure any and all necessary permits, licenses or other authorizations required for the lawful and proper installation and maintenance upon the Property of wires, pipes, conduits, tubes and other equipment and appliances for use in supplying any such services to and upon the Property.

ARTICLE X

Mechanics' Liens

Section 10.1. Lessee shall not suffer or permit any mechanics' liens to be filed against the Property nor against Lessee's leasehold interest in the Property by reason of

work, labor, services or materials supplied or claimed to have been supplied to Lessee or anyone holding the Property or any part thereof through or under Lessee. If any such mechanics' lien shall at any time be filed, Lessee shall, within thirty (30) days after notice of the filing thereof, cause the same to be discharged of record by payment, deposit, bond, order of a court of competent jurisdiction or otherwise, or deposit with Lessor or Assignee the amount of such lien together with all interest and penalties that may or might accrue thereon (any balance remaining after the discharge of such lien of record to be returned, without interest, to Lessee). If Lessee shall fail to cause such lien to be discharged within the period aforesaid, then, in addition to any other right or remedy of Lessor, Lessor, if at any time Lessor believes that the nonpayment of such lien may subject the Property or some part thereof to forfeiture or loss, may, but shall not be obligated to, discharge the same either by paying the amount claimed to be due or by procuring the discharge of such lien by deposit or by bonding proceedings, and in any such event Lessor shall be entitled, if Lessor so elects, to compel the prosecution of an action for the foreclosure of such mechanics' lien by the lienor and to pay the amount of the judgment for and in favor of the lienor with interest, costs and allowances. Any amount paid by Lessor, in excess of any amount so deposited with Lessor or Assignee, for any of the aforesaid purposes with interest thereon at the rate of ten per centum (10%) per annum from the date of payment shall be repaid by Lessee to Lessor on demand, and if unpaid may be treated as Additional Rent as provided in Section 4.1 hereof. Nothing in this Lease contained shall be deemed or construed in any way as constituting the consent or request of Lessor, express or implied, by inference or otherwise, to any contractor, subcontractor, laborer or materialman for the performance of any labor or the furnishing of any materials for any specific improvement, alteration or repair of

or to the Property or any part thereof, nor as giving Lessee a right, power or authority to contract for or permit the rendering of any services or the furnishing of any materials that would give rise to the filing of any mechanics' lien against the Property.

ARTICLE XI

Indemnification of Lessor

Section 11.1. Lessee agrees to indemnify and save Lessor harmless against and from any and all claims by or on behalf of any person or persons, firm or firms, corporation or corporations, arising from the conduct or management of or from any work or thing whatsoever done in and on the Property and will further indemnify and save Lessor harmless against and from any and all claims arising during the term of this Lease from any condition of the Property or any street, curb or sidewalk adjoining the Property, or of any vaults, tunnels, passageways or space therein or appurtenant thereto, or arising from any breach or default on the part of Lessee in the performance of any covenant or agreement on the part of Lessee to be performed, pursuant to the terms of this Lease, or arising from any act or negligence of Lessee, or any of its agents, contractors, servants, employees, or licensees or arising from any accident, injury or damage whatsoever caused to any person, firm or corporation occurring during the term of this Lease, in or about the Property, or upon or under the sidewalks and the land adjacent thereto, and from and against all costs, expenses and liabilities incurred in or in connection with any such claim or action or proceeding brought thereon; and in case any action or proceeding be brought against Lessor by reason of any such claim, Lessee upon notice from Lessor convenants to resist and defend such action or proceeding and to employ counsel therefor satisfactory to Lessor. Lessee covenants and agrees to pay, and to in-

demnify Lessor against, all legal costs and charges including counsel fees lawfully and reasonably incurred in obtaining possession of the Property after default of Lessee or after Lessee's default in surrendering possession upon expiration or earlier termination of the term of this Lease or enforcing any covenant or agreement of Lessee herein contained.

ARTICLE XII

Additional Rent, Payment of Taxes, Assessment, Etc.

Section 12.1. Lessee covenants and agrees to pay as Additional Rent (subject as hereinafter provided), before any fine, penalty, interest or cost may be added thereto for the nonpayment thereof, all real estate taxes, personal property taxes, assessments, water rates and water charges, and other governmental levies and charges, general and special, ordinary and extraordinary, unforeseen as well as foreseen, of any kind and nature whatsoever (all of which taxes, assessments, water rates or water charges, and other governmental levies and charges are hereinafter referred to as "imposition" or "impositions"), which are assessed, levied, confirmed, imposed or become a lien upon the Property or any part thereof or become payable during the term of this Lease. If, by law, any such imposition is payable, or may at the option of the taxpayer be paid, in installments (whether or not interest shall accrue on the unpaid balance of such imposition), Lessee may pay the same (and any accrued interest on the unpaid balance of such imposition), in installments as the same respectively become due and before any fine, penalty, interest or cost may be added thereto for the non-payment of any such installment and interest. Any imposition relating to a fiscal period of the taxing authority, a part of which period is included within the term of this Lease and a part of which is included in a period of time after the expira-

tion of this Lease shall (whether or not such imposition shall be assessed, levied, confirmed, imposed or become a lien upon the Property, or shall become payable during the term of this Lease) be adjusted between Lessor and Lessee as of the expiration of this Lease.

Section 12.2. Nothing in this Lease contained shall require Lessee to pay any franchise, corporate, estate, inheritance, succession, capital levy or transfer tax of Lessor, or any income, profit or revenue tax or any other tax, assessment, charge or levy upon the rent payable by Lessee under this Lease, nor shall any tax, assessment, charge or levy of the character hereinabove in this Section described be deemed to be included within the term "imposition' as defined in Section 12.1. If at any time during the term of this Lease under the laws of the State of Arkansas or any political subdivision thereof a tax or excise on rents is levied or assessed against Lessor or the Basic Rent, as a substitution in whole or in part for taxes assessed or imposed by said State or any political subdivision thereof on land, buildings or personal property, the same shall be deemed to be included within the term "imposition" as defined as aforesaid, and Lessee covenants (but to the extent only that such substitution so far as ascertainable relieves Lessee from the payment of impositions as in Section 12.1 provided) to pay and discharge such tax or excise on rent in accordance with the provisions of Section 12.1 in respect of the payment of impositions. If Lessee shall be required by law to pay, and pursuant to such requirement does pay, any such tax, assessment, charge or levy in this Section described Lessor shall, upon written request, reimburse Lessee for any such payments with interest at six per centum (6%) per annum (other than payments made by Lessee pursuant to the provisions in the preceding sentence in respect of a tax or excise on rents levied or assessed as a substitution in whole or in part for taxes assessed or imposed on land, buildings or personal property).

SECTION 12.3. Within a reasonable time after a request therefor is made by Lessor, Lessee covenants to furnish to Lessor for its inspection official receipts of the appropriate taxing authority, or other proof satisfactory to Lessor, evidencing the payment of any imposition payable by Lessee as provided in this Article.

SECTION 12.4. Lessee shall have the right to contest the amount or validity of any such imposition by appropriate proceedings. Lessee shall, nevertheless, promptly pay such imposition in accordance with the terms and provisions of this Lease, and nothing herein shall imply any right on the part of Lessee to postpone or defer such payment for any such purpose, unless such proceedings shall operate to prevent or stay the collection of the imposition so contested and the sale of the Property, or any part thereof, to satisfy the same. Lessee shall set aside on its books adequate reserves with respect to such contested liability and shall furnish such security, if any, as may be required in the proceedings or reasonably requested by Lessor or Assignee, which security may include a deposit by Lessee with Lessor of a sum equal to the amount so contested and unpaid together with all interest and penalties in connection therewith and all charges that may or might be assessed against or become a charge on the property, or any part thereof, in said proceedings. Upon the termination of such proceedings, Lessee shall pay the amount of any such imposition, or part thereof, as finally determined in such proceedings, the payment of which may have been deferred during the prosecution of such proceedings, together with any costs, fees, interest, penalties or other liabilities in connection therewith, and upon such payment, Lessor shall return the amount of any deposit above referred to without interest. If at any time during the continuance of such proceedings Lessor shall deem the amount deposited with it insufficient, Lessee shall, upon demand, deposit with Lessor such additional sum

as Lessor may reasonably request, and upon failure of Lessee so to do, the amount theretofore deposited may be applied to the payment, removal and discharge of said imposition and the interest and penalties in connection therewith and any costs, fees or other liabilities accruing in any such proceedings, and the balance, if any, shall be returned to Lessee, provided Lessee is not in default hereunder. If the amount so deposited shall be insufficient for this purpose, Lessee shall forthwith pay to Lessor such additional sum as may be necessary to pay the same. Lessor shall not be required to join in any such proceedings except that if any law hereafter in effect shall require that such proceedings be brought by or in the name of Lessor or any owner of the Property, Lessor agrees not unreasonably to withhold its consent to joining in any such proceedings, or permittting the same to be brought in its name. Lessor shall not be subjected to any liability for the payment of any costs or expenses in connection with any such proceeding, and Lessee covenants to indemnify and save harmless Lessor from any such costs or expenses. Lessee shall be entitled to any refund of any such imposition and penalties or interest thereon, which shall have been paid by Lessee, or if paid by Lessor, for which Lessor shall have been fully reimbursed.

SECTION 12.5. The certificate, advice or bill of the appropriate official designated by law to make or issue the same or to receive payment of such imposition, of nonpayment of any such imposition shall be prima facie evidence that such imposition is due and unpaid at the time of the making or issuance of such certificate, advice or bill.

ARTICLE XIII

COMPLIANCE WITH ORDERS, ORDINANCES, ETC.

SECTION 13.1. Lessee covenants throughout the term of this Lease, at Lessee's sole cost and expense, promptly to comply with all requirements of all laws, orders, ordi-

nances, rules and regulations of the Federal, state, county and municipal authorities, and with any direction or certificate of occupancy of any public officer or officers, and the orders, rules and regulations of the National Board of Fire Underwriters and each other body having similar functions, and with the requirements of all policies of public liability, fire and other insurance at any time in force with respect to the Property, which shall impose any duty upon the Lessee with respect to the Property or the use, occupancy or control thereof or the conduct of any business therein, whether or not any of the same require structural repairs or alterations.

SECTION 13.2. Lessee shall have the right to contest by appropriate legal proceedings, in the name of Lessee or Lessor or both, but without cost or expense to Lessor, the validity of any law, ordinance, order, rule, regulation or requirement of the nature referred to in Section 13.1 and if by the terms of any such law, ordinance, order, rule, regulation or requirement, compliance therewith may legally be held in abeyance without the incurrence of any lien, charge or liability of any kind against the fee of the Property or Lessee's leasehold interest in said Property and without subjecting Lessee or Lessor to any liability, civil or criminal, of whatsoever nature for failure so to comply therewith, Lessee may postpone compliance therewith until the final determination of any proceedings, provided that all such proceedings shall be prosecuted with all due diligence and dispatch, and, if any lien, charge or civil liability is incurred by reason of non-compliance, Lessee may nevertheless make the contest aforesaid and delay compliance as aforesaid, provided that Lessee furnishes to Lessor security reasonably satisfactory to Lessor against any loss or injury by reason of such non-compliance or delay therein and prosecutes the contest aforesaid with due diligence and dispatch.

SECTION 13.3. This Lease is upon and subject to all of the terms, covenants and agreements of the Ground Lease

described in granting clause (c) of Section 1.1 hereof. Lessee covenants to keep, perform and observe all of such terms, covenants and agreements on the part of the tenant thereunder to be kept, observed and performed, including the payment of all rent and other sums payable by the tenant thereunder. Lessee shall do all things necessary to prevent any default on the part of the tenant thereunder, or any termination, surrender, cancellation, forfeiture or impairment thereof, to the end that the rights of Lessor, as tenant thereunder, may be kept unimpaired and free from default.

SECTION 14.1. Lessee shall, at Lessee's sole cost and expense, throughout the term of this Lease:

A. Keep the Property insured against loss or damage by fire and lightning and such other risks as are insurable against under the present or future standard forms of extended coverage insurance, in amounts not less than one hundred per centum (100%) of then full insurable value;

B. Keep the Property insured against war risks as and when such insurance is obtainable from the United States of America or an agency thereof, in an amount not less than one hundred per centum (100%) of then full insurable value;

C. Keep the Property insured in an amount not less than ten per centum (10%) of then full insurable value against loss or damage from leakage of sprinkler systems now or hereafter installed therein;

D. Keep the Property insured against loss or damage by explosion of steam boilers, pressure vessels or similar apparatus, with respect to all steam boilers, pressure vessels or similar apparatus, now or hereafter installed therein, in an amount not less than $100,000 with respect to any one accident; and

E. Keep the Property insured as reasonably required by Lessor or Assignee and against all risks insured against by prudent persons owning like properties in like localities, giving due regard to the height and type of building, its construction, location, use and occupancy.

The term "full insurable value" shall mean the actual replacement cost (excluding foundation and excavation cost for the purposes of the foregoing Subsections A and C but including such foundation and excavation costs for the purposes of the foregoing Subsection B), less physical depreciation, and said "full insurable value" shall be determined from time to time at the request of Lessor (but not more frequently than once in every twelve (12) months' period) by an architect, contractor, appraiser, appraisal company or one of the insurers selected and paid by Lessee and acceptable to Lessor.

All insurance for which provision has been made in Subsection E of this Section shall be maintained in such amounts as such insurance is usually carried by prudent persons enegaged in the same or a similar business; and all insurance therein provided for shall be effected under a valid and enforceable policy or policies issued by insurers of recognized responsibility.

The policy or other contract of insurance in respect of the hazard of the character described in Subsection D of this Section may provide in effect that the first $1,000 of loss sustained shall be paid by Lessee and that additional losses sustained, which are insured against under such policy or other contract of insurance, shall be paid by the insurer.

Any such insurance may be effected by policies of blanket insurance, which may cover other property not included, as well as the Property; provided however, that either (1) any such policy of blanket insurance shall specify therein, or (2) Lessee shall furnish Lessor with a written statement from the insurers under such policy specifying the amount of the total insurance allocated to the Property (which amount shall at all times be not less than the applicable amounts required by this Article); and provided, further, that in all other respects, any such policy shall comply with the other provisions of this Article.

SECTION 14.2. Lessee shall at Lessee's sole cost and expense, throughout the term of this Lease and for the mutual benefit of Lessor and Lessee, maintain general public liability insurance against claims for bodily injury or death occurring on, in or about the Property or any elevator or escalator therein and upon, in or about the adjoining streets, sidewalks and passageways thereof, such public liability insurance to afford protection to the limit of not less than $200,000 in respect of bodily injury or death to any one person, and not less than $1,000,000 in respect to bodily injury or death to any number of persons in any one accid t or occurance.

SECTION 14.3. All proceeds of policies of insurance in respect of hazards of the character described in Section 14.1 shall be payable to Lessor or Assignee, as its interest may appear (by means of the standard mortgagee clause without contribution, if obtainable). The loss, if any, under any such policy shall be adjusted with the insurance companies (a) by Lessee in case of any particular casualty resulting in a loss payment not exceeding $50,000 in the aggregate, or (b) by Lessor and Lessee in the case of any particular casualty resulting in a loss payment exceeding $50,000 in the aggregate; provided, however, that the loss, if any, under any such policy shall be adjusted with the insurance companies by Lessor and Lessee in the case of any particular casualty resulting in a loss payment exceeding $200,000 in the aggregate only if the Assignee shall have consented to such adjustment. The loss so adjusted

shall be paid (i) to Lessee in the case of any particular casualty resulting in a loss payment not exceeding $50,000 in the aggregate, or (ii) to Lessor or to the Assignee in the case of any particular casualty resulting in a loss payment exceeding $50,000 in the aggregate. All such policies or certificates therefore issued by the respective insurers shall provide that the loss, if any, thereunder shall be adjusted and paid as provided in this Lease.

SECTION 14.4. All insurance provided for in this Article shall be effected under valid and enforceable policies issued by insurers of recognized responsibility satisfactory to Lessor, and such policies shall name Lessor and Lessee as the assureds, as their respective interests may appear. All policies of insurance provided for in Section 14.1, shall provide (a) that such policies shall not be cancelled without at least ten (10) days' prior written notice to each assured named therein and to the Assignee to whom loss thereunder may be payable, and (b) to the extent obtainable, that any loss shall be payable to Lessor or to the Assignee, notwithstanding any act or negligence of Lessee which might otherwise result in forfeiture of said insurance.

SECTION 14.5 Promptly upon request and thereafter not less than fifteen (15) days prior to the expiration dates of the expiring policies, originals of the policies provided for in Section 14.1 and certificates issued by the respective insurers of the policies provided for in Section 14.2, shall be delivered to Lessor and Assignee. Within twenty (20) days after each Quarterly Installment Date, Lessee will furnish satisfactory evidence to Lessor and Assignee that, as to all policies or contracts so delivered with respect to which the amount of premiums thereon shall have been determined and shall have become due and payable during such quarterly period, payment of all such premiums has been made. Lessee shall also furnish to Lessor and Assignee upon the execution of this Lease and thereafter at

any time upon Lessor's request, a certificate signed by an executive officer of Lessee, containing a statement of the insurance effected by Lessee pursuant to this Article and then in force and stating that the insurance then in force complies with the provisions of this Article, together with such evidence in support of such certificate as Lessor and Assignee may reasonably require. The premiums on all insurance policies in force at the termination of this Lease shall be apportioned between Lessor and Lessee in such manner that Lessor shall reimburse Lessee for that portion of the aggregate premiums unearned on all such policies in force at such termination of this lease.

ARTICLE XV

CHANGES AND ALTERATIONS BY LESSEE

SECTION 15.1. Unless an Event of Default (as defined in the Deed of Trust) shall have occurred which shall not have been remedied, Lessee shall have the right, at any time and from time to time during the term of this Lease, to make such changes and alterations, structural or otherwise, to the Property as Lessee shall deem necessary or desirable in connection with the requirements of its business, including, without limiting the foregoing, the right to connect any building with any adjoining building or buildings or part thereof. Such changes, alterations or new construction (herein collectively referred to as "changes and alterations" or "changes or alterations"), other than changes or alterations of Lessees personal property and fixtures, shall be made in all cases subject to the following conditions which Lessee covenants and agrees to observe and perform:

A. No change or alteration shall be undertaken or carried on until Lessee shall have procured and paid for, so far as the same may be required, from time to time, all municipal and other governmental permits

and authorizations of the various municipal departments and governmental subdivisions having jurisdiction which are required for the completion of such change or alteration, and Lessor agrees to join in the application for such permits or authorizations whenever such action is necessary.

B. The building or buildings as so altered or improved, upon completion of the work, shall be of a value not less than the value of such building or buildings immediately prior to the making of such alteration or improvement.

C. Any change or alteration involving an estimated cost of more than $100,000 shall be conducted under the supervision of an architect or engineer selected by Lessee, who may be in the employ of Lessee and shall be satisfactory to Lessor, and no such change or alteration shall be undertaken until twenty-five (25) days after there shall have been filed with Lessor detailed plans and specifications and cost estimates therefor, prepared and approved in writing by such architect or engineer and accompanied by a certificate of such architect or engineer stating that such plans and specifications conform to all applicable provisions of this Article, and during such 25-day period Lessor shall not have served notice on Lessee that it is not satisfied with said architect or engineer.

D. No change or alteration involving an estimated cost of more than $250,000 shall be undertaken until either (1) Lessor shall have been furnished by Lessee, at Lessee's expense, with a bond in which Lessee shall shall be principal and a surety company of recognized responsibility shall be surety, and which, at Lessor's request, shall run in favor of the Assignee, and which shall be in form satisfactory to Lessor, conditioned upon the completion of and payment in full for such

change or alteration within a reasonable time, subject, however to Unavoidable Delays, or (2) Lessee shall have deposited with Lessor a sum sufficient to pay the entire cost of any such change or alteration as estimated by the architect or engineer referred to in Subsection C of this Section.

E. Moneys deposited with Lessor pursuant to the foregoing Subsection D may be withdrawn by Lessee, provided Lessee is not in default in the payment of the Basic Rent, or any item of Additional Rent or other charge payable by Lessee hereunder and shall be paid by Lessor as hereinafter provided, from time to time, upon receipt by the Lessor of the following:

(1) A certificate of the architect or engineer referred to in Subsection C of this Section dated dated not more than thirty (30) days prior to the application for such withdrawal setting forth in substance as follows:

(i) That the sum then requested to be withdrawn either has been paid by Lessee and/or is justly due to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered services or furnished materials for any such change or alteration, pursuant to the plans and specifications therefor referred to in Subsection C of this Section and giving a brief description of such services and the materials and the principal subdivisions or categories thereof and the several amounts so paid or due to each of said persons in respect thereof, and stating the progress of such change or alteration pursuant to said plans and specifications up to the date of said certificate, and

that, so far as they are applicable to the conduct of such change or alteration, the provisions of Subsections A and G of this Sec- have been duly and fully compiled with;

(ii) That the sum then requested to be withdrawn, plus all sums previously withdrawn on account of such change or alteration, does not exceed the total cost thereof in so far as actually accomplished up to the date of such certificate, and that in the opinion of said architect or engineer the remaining moneys so deposited with Lessor will be sufficient to pay in full for the completion of such change or alteration; and

(iii) That, except for the amounts, if any stated in said certificate, pursuant to Subclause (i) of this Clause, to be due for services or materials, there is not outstanding indebtness known, after due inquiry, to said architect or engineer, which is then due and payable for labor, wages, services, materials or supplies in connection with such change or alteration which, if unpaid, might become the basis of a vendors', mechanics', laborers', materialmen's, statutory or other similar lien upon the Property or any part thereof.

(2) An affidavit sworn to by an executive officer of Lessee not more than thirty (30) days prior to the application for such withdrawal setting forth in substance as follows:

(i) That al' materials and all property constituting the changes and alterations described in said certificate pursuant to the foregoing Clause (1) of this Subsection and every part thereof, are free and clear of all encum-

brances, except those created by Lessor and undetermined or inchoate liens or charges for indebtedness incidental to such changes and alterations and which have not at the time been filed pursuant to law, and except encumbrances, if any, securing indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said certificate pursuant to the foregoing Clause (1) of this Subsection, which encumbrances will be discharged upon payment of such indebtedness;

(ii) That no part of the several amounts paid and/or due, as stated in said certificate pursuant to the foregoing Clause (1) of this Subsection, has been or is being made the basis of the withdrawal of any money so deposited with Lessor in any previous or then pending application, or has been paid out of the proceeds of insurance received by Lessee as provided in Section 14.3 hereof;

(iii) That the provisions of Subsection G of this Section have been duly and fully complied with; and

(3) An official search or other evidence satisfactory to Lessor showing that there has not been filed with respect to the Property any mechanics' of other lien which has not been discharged of record, except such as will be discharged upon payment of the amount then requested.

Upon compliance with the foregoing provisions of this Subsection E, Lessor shall, on Lessee's request, pay to the persons named in said certificate pursuant to Clause (1) (i) of this Subsection the respective amounts stated in said certificate to be due to them

and/or pay to Lessee the amount stated in said certificate to have been paid by Lessee. Lessee agrees to file a notice of completion of such changes and alterations promptly, and not less than one hundred twenty (120) days nor more than one hundred thirty (130) days after the filing of such notice Lessee shall furnish to Lessor an official search or other evidence satisfactory to Lessor showing that there has not been filed with respect to the Property any mechanics' or other lien which has not been discharged of record.

In the event that any change or alteration made under this Article shall be made in conjunction with the restoration, repair or replacement required to be made by Lessee under Article XVII or Article XVIII, the amount of the bond to be furnished or the deposit to be made under Subsection D of this Section need not exceed the aggregate cost of the work under both this Article and Article XVII or Article XVIII, as the case may be (as estimated by the architect or engineer referred to in Subsection C of this Section), less the proceeds of any insurance or proceeds of a condemnation award received by Lessor or the Assignee and which are applicable to work to be done by Lessee under Article XVII or Article XVIII, as the case may be. Any moneys deposited pursuant to Subsection D shall not be used or disbursed until such proceeds of any insurance or proceeds of a condemnation award shall have been fully withdrawn and paid over in the manner and to the extent provided in Article XVII or Article XVIII for such alteration, restoration, repair or replacement.

F. At any time after the completion in full, pursuant to the plans and specifications therefor previously submitted under Subsection C of this Section, of any change or alteration in respect whereof such moneys were deposited, the whole balance of moneys

so deposited with Lessor and then remaining on deposit may be withdrawn by Lessee, provided Lessee is not in default in the payment of the Basic Rent or any item of Additional Rent or other charge payable by Lessee hereunder, and shall be paid to Lessee upon receipt by Lessor of a certificate of the architect or engineer referred to in Subsection C of this Section dated not more than five (5) days prior to the application for such withdrawal setting forth in substance as follows:

(1) That such change or alteration in respect of which such moneys were deposited has been completed in full pursuant to the plans and specifications therefor previously filed with Lessor under Subsection C of this Section;

(2) That all amounts which Lessee is or may be entitled to withdraw under Subsection E of this Section on account of services rendered or materials furnished in connection with such change or alteration have been withdrawn under said Subsection E; and

(3) That all amounts for whose payment Lessee is or may become liable in respect of such change or alteration have been paid in full.

G. All work done in connection with any change or alteration shall be done promptly and in good and workmanlike manner and in compliance with the building and zoning laws of the municipality or other governmental subdivision wherein the Property is situated and with all laws, ordinances, orders, rules, regulations and requirements of all federal, state and municipal governments and the appropriate departments, commissions, boards and officers thereof, and in accordance with the orders, rules and regulations of the National Board of Fire Underwriters or any other body

now or hereafter constituted exercising similar functions; the cost of any such change or alteration shall be paid in cash or its equivalent, so that the Property shall at all times be free of liens for labor and materials supplied or claimed to have been supplied; and the work of any change or alteration shall be prosecuted with reasonable dispatch, Unavoidable Delays excepted. Workmen's compensation insurance covering all persons employed in connection with the work and with respect to whom death or bodily injury claims could be asserted against Lessor, Lessee or the Property, and general liability insurance for the mutual benefit of Lessee and Lessor, expressly covering the additional hazards due to any change or alteration, with limits of not less than $200,000 in the event of bodily injury or death to one person and not less than $1,000,000 in the event of bodily injury or death to any number of persons in any one accident, and with limits of not less than $50,000 for property damage, shall be maintained by Lessee at Lessee's sole cost and expense at all times when any work is in process in connection with any change or alteration. The general liability insurance provided for in this Subsection shall be in addition to the insurance required to be maintained by Lessee pursuant to Section 14.2 and may be effected by an appropriate endorsement, if obtainable, upon the insurance referred to in Section 14.2. All such insurance shall be in a company or companies of recognized responsibility, and all such policies or certificates therefor issued by the respective insurers shall be delivered to Lessor endorsed "Premium Paid" by the company or agency issuing the same or with other evidence of payment of the premiums satisfactory to Lessor.

SECTION 15.2. Lessee covenants and agrees that in performing any work or repairs to or restoration of the Property, required to be performed by Lessee pursuant to to the provisions of Article VII, Article XIII, Article XVII or Article XVIII, it will also observe and perform the conditions relating to changes and alterations set forth in Subsections A, B, C, and G of Section 15.1 to the extent that the nature and estimated cost of such repairs or restoration, if the same were changes or alterations made under this Article, would make such observance and performance applicable.

ARTICLE XVI

EXCAVATIONS ON ADJOINING PROPERTY AND VAULT SPACE

SECTION 16.1. If an excavation or other building operation shall be about to be made or shall be made upon any adjoining premises or streets, Lessee shall permit Lessor or Lessor's agents, or the owner or lessee of such adjoining premises, and their respective representatives, to enter the Property and to shore the foundations and walls of any building thereon, and to do any other act or thing necessary for the safety and preservation of the Property, and Lessor shall not be liable for any inconvenience, annoyance, disturbance, loss of business or other damage arising therefrom, and Lessee's obligation hereunder shall not thereby be affected. Lessor agrees in connection with any work done by Lessor pursuant to the provisions of this Article to cause as little inconvenience, annoyance and disturbance to Lessee as possible, consistent with the nature of the work involved. Nothing in this Article contained shall imply or be deemed to create any obligation upon Lessor to shore foundations or walls or to do any other act or thing necessary for the safety and preservation of the Property.

SECTION 16.2. All vaults, canopies, marquees or other structures now or hereafter built projecting beyond the building line of the Property are not included within the premises demised by this Lease, but Lessor covenants that

Lessee may occupy and use the same during the term of this Lease, subject only to such laws, rules and regulations as may be imposed by the appropriate municipal departments with respect thereto. No revocation on the part of any municipal department or authority of the license to maintain and use such vaults, canopies, marquees or other structures shall in any way affect this Lease or the amount of the Basic Rent or any item of Additional Rent or other charges payable by Lessee hereunder. If any such license so to maintain and use such vaults, canopies, marquees or other structures shall be revoked, Lessee will, at its sole cost and expense, do and perform all such work as may be necessary to comply with any order revoking the same. Lessor agrees to cooperate with Lessee in obtaining and renewing such license or licenses.

ARTICLE XVII

Damage or Destruction

Section 17.1. Lessee covenants and agrees that in case of damage to or destruction of the Property (except for Total Destruction as defined in Section 17.6 below) by fire or otherwise, it will promptly, at its sole cost and expense, restore, repair or replace the same as nearly as possible to the condition immediately prior to such damage or destruction or with such changes or alterations as Lessee may be permitted to make in conformity with Article XV. Such restoration, repairs, replacements, changes or alterations shall be commenced promptly and prosecuted to completion with all due diligence and in no event later than two years from the time of such damage or destruction, Unavoidable Delays excepted.

Section 17.2 Except as provided in Section 17.6, all insurance money recovered by Lessor or Assignee on account of such damage or destruction less the cost, if any, to Lessor or Assignee of such recovery, may be withdrawn by Lessee and shall be paid by Lessor or Assignee, as the

case may be, either to reimburse Lessee for expenditures made to repair, restore or replace the Property so damaged or destroyed (including expenditures made for temporary repairs or for the protection of the Property pending the completion of permanent repairs, restorations or replacements, or to prevent interference with the business operated thereon, and repairs, restorations and replacements then in process in so far as actually made or constructed) or to pay contractors, subcontractors, materialmen, engineers, architects or other persons who have rendered services or furnished materials for such repairs, restorations or replacements (hereinafter referred to as "Restoration" or as the "work"), and shall be paid out as hereinafter provided from time to time as such work progresses upon the written request of Lessee, which shall be accompanied by

A. A certificate of an architect or engineer in charge of the work (who shall be selected by Lessee, who may be in the employ of Lessee and who shall be satisfactory to Lessor and Assignee) dated not more than thirty (30) days prior to such request, setting forth in substance as follows:

(1) That the sum then requested to be withdrawn either has been paid by Lessee, and/or is justly due, to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered services or furnished materials for certain work, and giving a brief description of such services and materials and the principal subdivisions or categories thereof and the several amounts so paid and/or due to each of said persons in respect thereof, and stating the fair value of such work at the date of the acquisition thereof; and

(2) That, except for the amounts, if any, stated in said certificate pursuant to the foregoing Sub-

section A(1), to be due for services or materials, there is no outstanding indebtedness known to said architect or engineer, after due inquiry, which is then due and payable for labor, wages, materials, supplies or services in connection with such work which, if unpaid, might become the basis of a vendors', mechanics', laborers' or materialmen's statutory or other similar lien upon the Property or any part thereof.

B. An affidavit sworn to by an executive officer of Lessee not more than thirty (30) days prior to the application for such withdrawal setting forth in substance as follows:

(1) That all materials and all property constituting the work described in the said certificate pursuant to the foregoing Subsection A of this Section and every part thereof, are free and clear of all encumbrances, except those created by Lessor and undetermined or inchoate liens or charges for indebtedness incidental to the work and which have not at the time been filed pursuant to law, and except encumbrances, if any, securing indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said certificate pursuant to the foregoing Subsection A of this Section, which encumbrances will be discharged upon payment of such indebtedness;

(2) That no part of the several amounts paid and/or due, as stated in said certificate pursuant to the foregoing Subsection A of this Section, has been or is being made the basis of the withdrawal of any moneys pursuant to this Section or Section 18.3 in any previous or then pending application, or has been paid out of the proceeds of insurance

received by Lessee as provided in Section 14.3 hereof; and

(3) That there is no default in the payment of the Basic Rent or any item of Additional Rent or other charge payable by Lessee hereunder.

C. An official search or other evidence satisfactory to Lessor and Assignee showing that there has not been filed with respect to the Property any mechanics' or other lien which has not been discharged of record, except such as will be discharged upon payment of the amount then requested.

Upon compliance with the foregoing provisions of this Section, Lessor shall, out of such insurance money, on request of Lessee or Assignee, pay or cause to be paid to the persons named in the certificate, pursuant to the foregoing Subsection A(1), the respective amounts stated in said certificate to be due to them, and/or shall pay or cause to be paid to Lessee the amount stated in said certificate to have been paid by Lessee, provided, however, that such payments shall not exceed in amount the fair value as stated in said certificate of the relevant work. Lessee agrees to file a notice of completion of such changes and alterations promptly and not less than one hundred twenty (120) days nor more than one hundred thirty (130) days after the filing of such notice Lessee shall furnish to Lessor an official search or other evidence satisfactory to Lessor showing that there has not been filed with respect to the Property any mechanics' or other lien which has not been discharged of record.

If the insurance money in the hands of Lessor or Assignee shall be insufficient to pay the entire cost of such work, Lessee agrees to pay the deficiency.

SECTION 17.3. Lessee's obligation to make payment of the Basic Rent and all items of Additional Rent and other

charges on the part of Lessee to be paid and to perform all other covenants and agreements on the part of Lessee to be performed shall not be affected by any such destruction or damage of the Property and Lessee hereby waives the provision of any statute or law now or hereafter in effect contrary to such obligation of Lessee as herein set forth, or which releases Lessee therefrom.

SECTION 17.4. Notwithstanding the other provisions of this Article, any insurance moneys in the hands of Lessor or Assignee shall not be required to be paid out (nor shall Section 17.6 be operative) if Lessee is in default in the performance of any of the terms, covenants or conditions in this Lease contained in respect to a matter as to which notice of default has been given and has not been remedied within the time limited in this Lease. Any insurance moneys payable to Assignee pursuant to the provisions of Article XIV shall be disbursed by Assignee in accordance with and to the extent provided in this Article.

SECTION 17.5. In the event that in conjunction with any work required to be performed under this Article, Lessee shall make other changes or alterations in accordance with the applicable provisions and conditions in Article XV, and Lessee shall have furnished a bond or made the deposit required under Section 15.1D, the insurance money received by Lessor or Assignee shall, nevertheless, be used and applied to the payment of the cost of changes or alterations under Article XV as well as to the payment for work done under this Article, in the manner and to the extent in this Article provided before the money so deposited as aforesaid under Article XV shall be used or disbursed under the provisions of Section 15.1E thereof.

SECTION 17.6. As used herein, the term "Total Destruction" shall mean the destruction on or after December 1, 1980* of all or such a substantial part of the Property that

* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

the Board of Directors of Lessee (i) shall determine in its good faith judgment within sixty (60) days after such destruction that restoration is not economically feasible, (ii) shall give written notice to Lessor and Assignee of such determination within ten (10) days thereafter, and (iii) shall agree to purchase the Property on the date that the insurance proceeds are finally adjusted and paid to the Lessor or Assignee at a purchase price as hereinafter determined in this Section 17.6.

Said purchase price shall be determined pursuant to the termination table, attached hereto as Table A, interpolated on a daily basis between the immediately preceding and next succeeding option dates; provided, however, that if the amount then required under the provisions of the Note to fully prepay the same plus accrued interest and premium under the provisions thereof and to discharge all other obligations of the Lessor under the Deed of Trust exceeds said purchase price determined pursuant to said Table A, then the purchase price shall be such greater amount. Said insurance proceeds (less any cost of recovery) shall be applied in payment of Lessee's obligation hereunder; and said insurance proceeds, together with such additional amount, if any, as may be paid by Lessee as the purchase price of the Property pursuant to this Section, shall be applied in the following order of priority:

A. Such amount shall first be applied to pay the Assignee the amount then required under the provisions of the Note to fully prepay the same plus accrued interest and premium, and to discharge all other obligations of Lessor under the Deed of Trust.

B. The balance of such amount, if any, shall then be paid to the Lessor; provided that in no event will the amount paid to Lessor, when added to the amount paid pursuant to paragraph A, exceed said purchase price.

C. Any excess after making the payments provided for in paragraphs A and B above shall be paid to the Lessee.

On payment by Lessee of said purchase price, and Assignee's receipt of the entire amount specified in paragraph A of this Section and Lessor's receipt of the entire amount specified in paragraph B, Lessor at Lessee's expense shall convey the Property by general warranty deed to Lessee free of any mortgage, lien, or encumbrance unless created by Lessee's default hereunder.

The right of Lessee to purchase the Property as provided in this Section 17.6 shall be exercisable only upon condition that at the time of the exercise of such right there exists no default in the performance of any of the terms, covenants or conditions of this Lease upon the part of Lessee to be performed, and such purchase shall become effective only upon compliance with all such terms, covenants and conditions to the date thereof.

ARTICLE XVIII

Condemnation

Section 18.1. If, during the term of this Lease, all of the Property shall be taken as a result of the exercise of the power of eminent domain (hereinafter referred to as the "Taking" or as the "proceeding"), this Lease and all right, title and interest of Lessee hereunder shall cease and come to an end on the date of payment in full of the award as finally determined pursuant to such Taking, provided that Lessee shall pay a purchase price, which shall be determined and paid in accordance with Section 18.4 hereof in consideration for the assignment of all of Lessor's right, title and interest in and to such award with respect to the Property.

Section 18.2. If, during the term of this Lease, less than all of the Property shall be taken in any such Taking, and the Board of Directors of Lessee shall determine in its good faith judgment within sixty (60) days after such Taking that the injury, damage or loss suffered from such Taking cannot be so repaired, restored or replaced that the remainder thereof can be effectively used in the business of Lessee, Lessee shall give written notice to Lessor and Assignee of such determination within ten (10) days thereafter and shall agree to purchase the Property for a purchase price, which shall be determined and paid in accordance with Section 18.4.

Upon payment by Lessee of said purchase price and Lessor's receipt of the entire amount specified in paragraph B of Section 18.4 and Assignee's receipt of the entire amount specified in paragraph A of Section 18.4, Lessor at Lessee's expense shall convey the Property by general warranty deed to Lessee free of any mortgage, lien or encumbrance unless created by Lessee's default hereunder.

The right of Lessee to purchase the Property as provided in this Section 18.2 shall not apply prior to December 1, 1980, without the written consent of Lessor or Assignee and shall be exercisable only upon condition that at the time of the exercise of such right there exists no default in the performance of any of the terms, covenants or conditions of this Lease upon the part of Lessee to be performed. Such purchase shall become effective only upon compliance with all such terms, covenants and conditions to the date thereof.

Section 18.3. If, during the term of this Lease, less than all the Property shall be taken in any such proceeding and Lessee does not purchase the Property as in Section 18.2 provided, this Lease shall, upon the vesting of title in the proceeding, terminate only as to the part so taken, and Lessor shall be entitled to and shall receive the total award made in such proceeding, and Lessee hereby assigns such award to Lessor. In any such case, Lessee covenants and

agrees, at Lessee's sole cost and expense (subject to reimbursement to the extent hereinafter provided) and under the supervision of an architect or engineer selected by Lessee, who may be in the employ of Lessee and shall be satisfactory to Lessor or Assignee, promptly to restore, repair or replace that portion of the Property not so taken to a complete architectural unit or units for the use and occupancy of Lessee as in this Lease expressed. Lessor agrees, in connection with such restoration, repair or replacement, to apply or cause to be applied the net amount of any award for damage to said building or buildings that may be received by it in any such proceeding, either to reimburse Lessee for expenditures made (1) to repair or restore the remaining portion of such building or buildings so that the same shall constitute a complete architectural unit or units or (2) to replace on the remainder of the Property the portion of any such building or buildings so taken (which shall include expenditures made for temporary repairs or for the protection of the Property pending the completion of permanent repairs, restorations or replacements, or to prevent interference with the business operated thereon, and repairs, restorations and replacements then in process in so far as actually made or constructed) or to pay contractors, subcontractors, materialmen, engineers, architects or other persons who have rendered services or furnished materials for said repairs, restorations or replacements (but the amount so applied shall not include the cost of any alteration, construction, change or improvement that Lessee may desire to make that is not necessary to restore that portion of the building or buildings not so taken to a complete architectural unit of substantially the same usefulness, design and construction as immediately before such taking), and the said net award may be withdrawn and shall be paid out as hereinafter provided from time to time as such repair, restoration or replacement progresses upon the written request of Lessee, which shall be accompanied by

A. A certificate of the architect or engineer in charge of the repair, restoration or replacement, dated not more than thirty (30) days prior to such request, setting forth in substance as follows:

(1) That the injury, damage and loss from such Taking have been or can be so repaired, restored or replaced that the remaining portions of the Property can be effectively used in the business of Lessee;

(2) That the sum then requested to be withdrawn either has been paid by Lessee and/or is justly due to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated), who have rendered services or furnished materials for certain repairs, restorations or replacements, and giving a brief description of such services and materials and the principal subdivisions or categories thereof and the several amounts so paid and/or due to each of said persons in respect thereof, and also stating the fair value of such repairs, restorations or replacements at the time of acquisition thereof; and

(3) That, except for the amounts, if any, stated in said certificate pursuant to the foregoing Subsection A(2) to be due for services or materials, there is no outstanding indebtedness known, after due inquiry, to said architect or engineer, which is then due and payable for labor, wages, services, materials or supplies in connection with said repairs, restorations or replacements, which, if unpaid, might become the basis of a vendor's, mechanics', laborers' materialmen's statutory or other similar lien upon the Property or any part thereof.

B. An affidavit sworn to by an executive officer of Lessee not more than thirty (30) days prior to the application for such withdrawal setting forth in substance as follows:

(1) That all materials and all property constituting the repairs, restorations and replacements described in the said certificate pursuant to the foregoing Subsection A of this Section and every part thereof, are free and clear of all encumbrances, except those created by Lessor and undetermined or inchoate liens or charges for indebtedness incidental to such repairs, restorations and replacements and which have not at the time been filed pursuant to law, and except encumbrances, if any, securing indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said certificate pursuant to the foregoing Subsection A of this Section, which encumbrances will be discharged upon payment of such indebtedness;

(2) That no part of the several amounts paid and/or due, as stated in said certificate pursuant to the foregoing Subsection A of this Section, has been or is being made the basis of the withdrawal of any moneys pursuant to this Section or Section 17.2 in any previous or then pending application or has been paid out of the proceeds of insurance received by Lessee as provided in Section 14.3 hereof; and

(3) That there is no default in the payment of the Basic Rent or any item of Additional Rent or other charge payable by Lessee hereunder.

C. An official search or other evidence satisfactory to Lessor showing that there has not been filed with respect to the Property any mechanics' or other lien which has not been discharged of record, except such as will be discharged upon payment of the amount then requested.

Upon compliance with the foregoing provisions of this Section, Lessor shall, out of the proceeds of such net award, on request of Lessee, pay or cause to be paid to the persons named in the certificate, pursuant to the foregoing Subsection A(2), the respective amounts stated in said certificate to be due to them, and/or shall pay or cause to be paid to Lessee the amount stated in said certificate to have been paid by Lessee, *provided however,* that such payments shall not exceed in amount the fair value as stated in said certificate of the relevant repairs, restorations or replacements. Lessee agrees to file a notice of completion of such changes and alterations promptly and not less than one hundred twenty (120) days nor more than one hundred thirty (130) days after the filing of such notice, Lessee shall furnish to Lessor an official search or other evidence satisfactory to Lessor showing that there has not been filed with respect to the Property any mechanics' or other lien which has not been discharged of record.

If payment of the net award as aforesaid shall not be received by Lessor in time to permit payments as the work of repairs, restorations or replacements progresses, Lessee shall, nevertheless, perform and fully pay for such work without delay (except for Unavoidable Delays), and payment of the amount to which Lessee may be entitled shall thereafter be made by Lessor out of said net award as and when payment of such net award is received by Lessor. If the funds to be applied by Lessor as in this Section provided shall be insufficient to pay the entire cost of such repairs, restorations or replacements, Lessee agrees to pay the deficiency.

SECTION 18.4. The purchase price referred to in Section 18.1 and 18.2 hereof shall be determined pursuant to the

termination table, attached hereto as Table A, interpolated on a daily basis between the immediately preceding and next succeeding option dates; provided, however, that if the amount then required under the provisions of the Note to fully prepay the same plus accrued interest and premium under the provisions thereof and to discharge all other obligations of the Lessor under the Deed of Trust exceeds said purchase price determined pursuant to said Table A, then the purchase price shall be such greater amount. The total award for the Property in the proceeding (less any cost of recovery) shall be applied in payment of Lessee's obligation hereunder; and said award, together with such additional amount, if any, as may be paid by Lessee as the purchase price of the Property pursuant to this Section, shall be applied in the following order of priority.

A. Such amount shall first be applied to pay the Assignee the amount then required under the provisions of the Note to fully prepay the same plus accrued interest and premium, and to discharge all other obligations of Lessor under the Deed of Trust.

B. The balance of such amount, if any, shall then be paid to the Lessor; provided that in no event will the amount paid to Lessor, when added to the amount paid pursuant to paragraph A, exceed said purchase price.

C. Any excess after making the payments provided for in paragraphs A and B above shall be paid to the Lessee.

SECTION 18.5. Lessee and the Assignee shall each have the right in any Taking at its sole costs and expense to participate, by counsel of its own choice, in the proceeding and any appeals which may be taken therefrom. Notwithstanding anything in this Article contained to the contrary, in any Taking of the Property or any part thereof, whether or not this Lease is terminated as in this Article provided, Lessee shall have the right to prove in the proceeding and

to receive any award which may be made for damage to or condemnation of Lessee's personal property.

SECTION 18.6. A Taking of any vault or other space not included within the Property as above described, or a Taking which shall result merely in the removal of projecting portions of the building upon any street, or of a portion of the outer facing of the walls of said building not requiring the demolition or reconstruction of a main building wall, or a Taking of an underground right-of-way for a subway, conduit or other purpose not necessitating the demolition or substantial alteration of any portions of such building or buildings above the street level shall not be deemed a Taking of the Property for the purpose of this Article, and this Lease shall not be affected by any such Taking of the nature in this Section referred to. Any alteration required because of a Taking of the nature in this Section referred to shall be done by Lessee at its sole cost and expense and Lessor covenants and agrees to apply the net amount of any award, after deduction of all costs and expenses, that may be made for any such taking of the nature in this Section referred to for physical damage, if any, to the Property in the same manner as in Section 18.3 provided.

SECTION 18.7. If all or any portion of the Property shall be taken by the exercise of the right of eminent domain for governmental occupancy for a limited period, this Lease shall not terminate and Lessee shall continue to perform and observe all of its obligations hereunder as though such Taking had not occurred except only to the extent that it may be prevented from so doing by reason of such Taking. In the event of a Taking of the nature in this Section referred to for a period of time ending on or prior to the date specifically fixed for the expiration of the term hereof, Lessee shall be entitled to receive the entire amount of any award made for such Taking, whether paid by way of damages, rent or otherwise. In the event of such a Taking for a period which extends beyond the date specifically fixed

for the expiration of the term hereof, Lessee shall be entitled to receive that portion of any award made for such Taking (whether paid by way of damages, rent or otherwise), allocable to the period of time from the date of such a Taking to the date specifically fixed for the expiration of the term hereof, and Lessor shall be entitled to receive the balance of such award. Lessee covenants that at the termination of any such governmental occupancy, it will, at its sole cost and expense, restore the Property as nearly as may be reasonably possible to the condition prior to such taking, but Lessee shall not be required to do such restoration work (i) if on or prior to the date of such termination of governmental occupancy, the date specifically fixed for the expiration of the term of this Lease shall have occurred and (ii) if Lessee shall have paid to Lessor the portion, if any, of the award made in connection with any such Taking as compensation for the cost of restoring the Property to the condition prior to such taking.

ARTICLE XIX

Limitation of Lessor's Liability

Section 19.1. The term "*Lessor*" as used in this Lease so far as covenants or obligations on the part of Lessor are concerned, shall be limited to mean and include only the owner or owners at the time in question of the Property. In the event of any transfer or transfers of the title to the Property, Lessor herein named (and in case of any subsequent transfers or conveyances, the then grantor) shall be automatically freed and relieved from and after the date of such transfer and conveyance of all personal liability as respects the performance of any covenants or obligations on the part of Lessor contained in this Lease thereafter to be performed. Any funds in the hands of Lessor or the then grantor at the time of such transfer, in which Lessee has an interest, shall be turned over to the grantee. Any amount then due and payable to Lessee by Lessor or the

then grantor under any provision of this Lease shall be paid to Lessee. Upon any such transfer, the grantee or transferee shall expressly assume and agree to be bound by, subject to the limitations of this Article, all of the terms, covenants and conditions in this Lease contained to be performed on the part of Lessor, it being intended hereby that the covenants and obligations contained in this Lease on the part of Lessor shall, subject as aforesaid, be binding on Lessor, its successors and assigns, only during and in respect of their respective successive periods of ownership.

ARTICLE XX

Optional Purchase of Property

Section 20.1. Unless a default hereunder by Lessee shall have occurred and be continuing, Lessee, at its election, upon not less than thirty (30) days' prior written notice to Lessor and Assignee, may purchase the Property on any of the following dates, by paying to Lessor or Assignee a purchase price as follows:

DATE	PURCHASE PRICE
November 30, 1980*	$6,325,169.85
November 30, 1984*	$5,432,607.52
November 30, 1989*	$4,187,328.04
November 30, 1994*	$2,145,935.00

provided, that Lessee shall assume all indebtedness against the Property evidenced by the Note and shall be entitled to credit against such purchase price in the amount of such indebtedness assumed, if any, the balance of such purchase price to be paid in cash. Upon receipt of such purchase price and assumption of such indebtedness on any such date, this Lease shall terminate, and Lessor at the expense of

* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

Lessee will convey the Property to Lessee free of any mortgage, lien or encumbrance other than the Deed of Trust or which Lessee shall have directly or indirectly created or permitted to be created or to remain.

SECTION. 20.2. Anything in the foregoing Section 20.1 hereof to the contrary notwithstanding, this Lease shall terminate as provided in said Section 20.1 only upon compliance with the following conditions precedent to such termination:

A. Lessee shall have assumed all indebtedness evidenced by the Note and all obligations of the Lessor under the Deed of Trust pursuant to an assumption agreement (hereinafter called the "Assumption Agreement") in form, scope and substance satisfactory to the Assignee and its special counset.

B. Lessee shall have received, in form, scope and substance satisfactory to the Assignee, the formal approval of the Board of Governors of the Federal Reserve System to the purchase of the Property by Lessee and the consummation of the transactions contemplated by the Assumption Agreement, to the extent that such approval is required, or proof satisfactory to the Assignee that no such approval is required; and a copy of such approval, certified as a true copy by the President or a Vice President of Lessee, or such proof that no such approval is required, shall have been furnished to the Assignee.

C. Lessee shall have received, in form, scope and substance satisfactory to the Assignee, the formal approval of the Arkansas Bank Commissioner to the purchase of the Property by Lessee and the consummation of the transactions contemplated by the Assumption Agreement, to the extent that such approval is required, or a written ruling of said Commissioner that no such approval is required; and a copy of such approval or of such ruling, certified as a true copy by the President or a Vice President of Lessee, shall have been furnishd to the Assignee.

D. The Assumption Agreement shall have been duly executed and delivered by Lessee to the Assignee.

E. The execution and delivery of the Assumption Agreement shall not affect or reduce any of the obligations of the Lessor for payment of the indebtedness evidenced by the Note or performance of any of the terms, covenants or conditions of the Deed of Trust on the part of the Lessor to be performed.

F. The execution and delivery of the Assumption Agreement and performance thereof shall not result in any breach of, or constitute a default under, any indenture, mortgage, deed of trust, bank loan or credit agreement, corporate charter, by-law or other agreement or instrument to which Lessee is a party or by which Lessee is bound; and an Officers' Certificate to the foregoing effect and such other proof of the foregoing as the Assignee may require shall have been delivered to the Assignee.

G. The Assignee shall have received from counsel for Lessee and Messrs. House Holmes & Jewell, special counsel for the Assignee, opinions in scope and substance satisfactory to the Assignee, as to:

(i) the due authorization, execution and delivery of the Assumption Agreement and the legality, validity and enforceability thereof in accordance with its terms;

(ii) the formal approval of the Board of Governors of the Federal Reserve System to the purchase of the Property by Lessee and the consummation of the transactions contemplated by the Assumption Agreement, or to the effect that no such approval is required;

(iii) the formal approval of the Arkansas Bank Commissioner to the purchase of the Property by Lessee and the consummation of the transactions contemplated by the Purchase Agreement, or as to the written ruling of said Commissioner that no such approval is required;

(iv) such other matters incident to the purchase of the Property and assumption of the indebtedness and obligations of the Deed of Trust as the Assignee may reasonably request.

Lessee shall pay the fees and disbursements of special counsel for the Assignee for their services to the Assignee with relation to the transactions contemplated by this Article XX, including the furnishing of the foregoing opinions and any other opinions which the Assignee may request on questions incident to such contemplated transactions, and all printing, filing, recording and other expenses in connection with such transactions, and shall reimburse the Assignee for any and all out-of-pocket expenses in connection therewith.

ARTICLE XXI

Right of Lessor or Assignee to Perform Lessee's Covenants, Etc.

Section 21.1. If Lessee shall fail to make any payment or perform any act required to be made or performed hereunder, Lessor or Assignee, after not less than 10 days' prior written notice to or demand upon Lessee (or without notice in the event of an emergency) and without waiving or releasing any obligation or default, may (but shall be under no obligation to) at any time thereafter make such payment or perform such act for the account and at the expense of Lessee, and may enter upon the Property or any part thereof for such purpose and take all such action thereon as, in Lessor's or Assignee's opinion, may be necessary or appropriate therefor. No such entry shall be deemed an eviction of Lessee. All sums so paid by Lessor or Assignee and all costs, fees and expenses (including without limitation, attorneys' fees and expenses) so incurred, together with interest thereon at the rate of 10% from the date of payment

or incurring, shall constitute Additional Rent hereunder and shall be paid by Lessee to Lessor or Assignee on demand.

ARTICLE XXII

Certificate By Lessee

Section 22.1. Lessee agrees at any time and from time to time upon not less than ten (10) days prior notice by Lessor to execute, acknowledge and deliver to Lessor a statement in writing certifying that this Lease is unmodified and in full force and effect (or if there have been modifications, that the same is in full force and effect as modified and stating the modifications), and the dates to which the Basic Rent and any item of Additional Rent and other charges have been paid in advance, if any, and stating whether or not to the best knowledge of the signer of such certificate Lessee is in default in performance of any covenant, agreement or condition contained in this Lease and, if so, specifying each such default of which the signers may have knowledge, it being intended that any such statement delivered pursuant to this Article may be relied upon by any prospective purchaser of the Property or the holder of any mortgage or deed of trust or any assignee of any mortgage or deed of trust upon the Property.

ARTICLE XXIII

Inspection of Premises by Lessor, Etc.

Section 23.1. Lessee agrees to permit Lessor and the authorized representatives of Lessor to enter the Property at all reasonable times during usual business hours for the purpose of (a) inspecting the same and (b) making any necessary repairs to the Property and performing any work therein that may be necessary by reason of Lessee's default under the terms of this Lease. Nothing herein shall imply any duty upon the part of Lessor to do any such work which under any provisions of this Lease Lessee may be required

to perform and the performance thereof by Lessor shall not constitute a waiver of Lessee's default in failing to perform the same. Lessor shall not in any event be liable for inconveniences, annoyance, disturbance, loss of business or other damage of Lessee by reason of making such repairs or the performance of any such work in the Property, or on account of bringing materials, supplies and equipment into or through the Property during the course thereof, and the obligations of Lessee under this Lease shall not thereby be affected in any manner whatsoever. Lessor agrees, however, in connection with the making of such repairs or the performance of such work that it will cause as little inconvenience, annoyance, disturbance, loss of business or other damage to Lessee as may reasonably be possible under the circumstanecs.

ARTICLE XXIV

Assignment And Subletting

Section 24.1. Neither this Lease nor the term hereby demised shall, under any circumstances, be assigned, transferred or mortgaged by Lessee, its successors or assigns, or the personal representative of any assignee or transferee, without, in each case, the prior written consent of Lessor or Assignee being first had and obtained.

Section 24.2. Lessee shall have the right to sublet all or any part of the Property at any time or from time to time, but no such subletting shall affect or alter the Lessee's obligations hereunder.

ARTICLE XXV

Conditional Limitations—Default Provisions

Section 25.1. If, during the term of this Lease,

(a) Lessee shall make an assignment for the benefit of creditors, or

(b) a voluntary petition be filed by Lessee under any law having for its purpose the adjudication of Lessee a bankrupt, or the extension of the time of payment, composition, adjustment, modification, settlement or satisfaction of the liabilities of Lessee or to which any property of Lessee may be subject, or under any law having for its purpose the reorganization (other than a merger in which the Lessee is the surviving corporation) or liquidation of Lessee, or

(c) any proceeding against Lessee of the type referred to in clause (b) above seeking any such relief shall not have been dismissed within sixty (60) days after the commencement thereof, or

(d) a permanent receiver be appointed for the property of Lessee by order of a court of competent jurisdiction by reason of the insolvency or alleged insolvency of Lessee, or

(e) any department of the state or federal government, or any officer thereof duly authorized, shall take possession of the business or property of Lessee by reason of the insolvency or alleged insolvency of Lessee,

Lessor may, at its option, give to Lessee a notice of election to end the term of this Lease at the expiration of five (5) days from the date of service of such notice. If such notice is given, then at the expiration of said five (5) days the term of this Lease and all right, title and interest of Lessee hereunder shall expire as fully and completely as if that day were the date herein specifically fixed for the expiration of the term of this Lease, and Lessee will then quit and surrender the Property to Lessor, but Lessee shall remain liable as hereinafter provided in this Article XXV.

Section 25.2. If, during the term of this Lease,

(a) Lessee shall make default in fulfilling any of the covenants of this Lease (other than the covenants for the payment of the Basic Rent or any items of Additional Rent or other charges payable by Lessee hereunder), or

(b) The Property shall be used in violation of Article VI or Article XIII hereof, or

(c) the Property shall be left vacant or unoccupied or be deserted for a period of ninety (90) days, unless caused by Unavoidable Delays, or

(d) this Lease, without the prior written consent of Lessor and Assignee shall be assigned or transferred in any manner or shall, by operation of law, pass to or devolve upon any third party,

Lessor may give to Lessee notice of any such default or of the happening of any contingency in this Section referred to. If at the expiration of sixty (60) days after the service of such notice the default or the happening of the contingency upon which said notice was based shall continue to exist, or in the case of a default or contingency which cannot with due diligence be cured within a period of sixty (60) days, if Lessee fails to proceed promptly after the service of such notice and with all due diligence to cure the same and thereafter to prosecute the curing of such default with all due diligence (it being intended that in connection with a default not susceptible of being cured with due diligence within sixty (60) days that the time of Lessee within which to cure the same shall be extended for such period as may be necessary to complete the same with all due diligence), Lessor may give to Lessee a notice of intention to end the term of this Lease at the expiration of five (5) days from the date of the service of such second notice. At the expiration of said five (5) days, the term of this Lease and all right, title and interest of Lessee hereunder shall expire as fully and completely as if that day were the date herein specifically fixed for the expiration of the term, and Lessee will then quit and surrender the Property to Lessor, but Lessee shall remain liable as hereinafter provided in this Article XXV.

SECTION 25.3. If Lessee shall make default in the payment of the Basic Rent expressly reserved hereunder or any part of the same, and such default shall continue for fifteen (15) days after notice thereof by Lessor, or shall make default in the payment of any item of Additional Rent or other charge required to be paid by Lessee hereunder or any part of the same, and such default shall continue for thirty (30) days after notice thereof by Lessor, or if this Lease shall expire as in Section 25.1 or Section 25.2 provided, Lessor or Lessor's agents and servants may immediately or at any time thereafter reenter the Property and remove all persons and all or any property therefrom, either by summary dispossess proceedings or by any suitable action or proceeding at law, or by force or otherwise, without being liable to indictment, prosecution or damages therefor, and repossess and enjoy said premises, as of their former estate, together with all additions, alterations and improvements.

SECTION 25.4. Upon the expiration of the term of this Lease by reason of the happening of any of the events hereinabove described in Section 25.1, Section 25.2, or Section 25.3, or in the event of the termination of this Lease by summary dispossess proceedings or under any provision of law now or at any time hereafter in force, by reason of or based upon or arising out of default under or breach of this Lease on the part of Lessee, or upon Lessor recovering possession of the Property in the manner or in any of the circumstances hereinabove mentioned, or in any other manner or circumstances whatsoever, whether with or without legal proceedings, by reason of or based upon or arising out of a default under or breach of this Lease on the part of Lessee, then Lessor may, at its option, at any time, and from time to time, relet the Property or any part or parts thereof for the account of Lessee or otherwise, and receive and collect the rents therefor, applying the same first to the payment of such expenses as Lessor may have incurred in recovering possession of the Property, including legal expenses and attorney's fees, and for putting the same into

good order or condition or preparing or altering the same for re-rental, and expenses, commissions and charges paid, assumed or incurred by Lessor in and about the reletting of the Property, and then to the fulfillment of the covenants of Lessee hereunder. Any such reletting herein provided for may be for the remainder of the term of this Lease or for a longer or shorter period. In any such case and whether or not the Property or any part thereof be relet, Lessee shall pay to Lessor the Basic Rent and any items of Additional Rent and all other charges required to be paid by Lessee up to the time of such termination of this Lease, or of such recovery of possession of the Property by Lessor, as the case may be. Thereafter, Lessee covenants and agrees, if required by Lessor, to pay to Lessor until the end of the term of this Lease the equivalent of the amount of all the Basic Rent reserved herein and any items of Additional Rent and all other charges required to be paid by Lessee, less the net avails of reletting, if any. The same shall be due and payable by Lessee to Lessor on the several rent days above specified, that is to say, upon each of such rent days Lessee shall pay to Lessor the amount of the deficiency then existing. In any of the circumstances hereinabove mentioned in which Lessor shall have the right to hold Lessee liable upon the several rent days herein specified to pay Lessor the equivalent of the amount of all the Basic Rent and any items of Additional Rent and all other charges required to be paid by Lessee less the net avails of reletting, if any, Lessor shall have the election in place and in stead of holding Lessee so liable, forthwith to recover against Lessee, as damages for loss of the bargain and not as a penalty, an aggregate sum which, at the time of such termination of this Lease, or of such recovery of possession of the premises by Lessor, as the case may be, represents the then present worth of the excess, if any, of the aggregate of the Basic Rent and any items of Additional Rent and all other charges payable by Lessee hereunder that would have accrued for the balance of the term over the

aggregate rental value of the Property for the balance of such term. Nothing herein contained shall limit or prejudice Lessor's right to prove and obtain as liquidated damages arising out of any termination of this Lease as a result of a happening of any of the contingencies referred to in Section 25.1, Section 25.2 or Section 25.3 the maximum amount allowed by any such statute or rule of law which may govern such proceeding in which such damages are to be proved, whether such amount be greater, equal to or less than the amount of the then present worth of the excess of the Basic Rent and any items of Additional Rent and all other charges payable by Lessee hereunder over the rental value referred to above.

Section 25.5. Lessee hereby expressly waives the service of notice of intention to re-enter provided for in any statute now or hereafter in force, or to institute legal proceedings to that end, and also waives any and all right of redemption provided for in any statute now or hereafter in force in case Lessee shall be dispossessed by a judgment or by warrant of any court or judge. Lessee also waives and will waive any and all right to a trial by jury provided for in any statute now or hereafter in force in the event that summary proceedings or any other action or proceeding shall be instituted by Lessor. The terms "enter", "re-enter", "entry" or "re-entry", as used in this Lease, are not restricted to their technical legal meaning.

ARTICLE XXVI

Cumulative Remedies—No Waiver

Section 26.1. The specific remedies to which Lessor or Lessee may resort under the terms of this Lease are cumulative and are not intended to be exclusive of any other remedies or means of redress to which they may be lawfully entitled in case of any breach or threatened breach by either of them of any provision of this Lease. The failure of Lessor to insist in any one or more cases upon the strict

performance of any of the covenants of this Lease, or to exercise any option herein contained, shall not be construed as a waiver or relinquishment for the future of such covenant or option. A receipt by Lessor of rent with knowledge of the breach of any covenant hereof shall not be deemed a waiver of such breach, and no waiver, change, modification or discharge by either party hereto of any provisions in this Lease shall be deemed to have been made or shall be effective unless expressed in writing and signed by both Lessor and Lessee. In addition to the other remedies in this Lease provided, Lessor and Lessee shall be entitled to the restraint by injunction of the violation, or attempted or threatened violation, of any of the covenants, conditions or provisions of this ease or to a decree compelling performance of any of such covenants, conditions or provisions.

ARTICLE XXVII

Invalidity of Particular Provisions

Section 27.1. If any term or provision of this Lease or the application thereof to any person or circumstances shall, to any extent, be invalid or unenforceable, the remainder of this Lease, or the application of such term or provision to persons or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected thereby, and each term and provision of this Lease shall be valid and be enforced to the fullest extent permitted by law.

ARTICLE XXVIII

Notices

Section 28.1. All notices, demands and requests which may or are required to be given by either party to the other shall be in writing. All notices, demands and requests by Lessor to Lessee shall be deemed to have been properly

given if served personally on an executive officer of Lessee, or if sent by United States first class registered mail, postage prepaid, addressed to Lessee at the Property, or at such other place as Lessee may from time to time designate in a written notice to Lessor. All notices, demands and requests by Lessee to Lessor shall be deemed to have been properly given if served personally on an executive officer of Lessor, or if sent by United States first class registered mail, postage prepaid, addressed to Lessor at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas 72206, or at such other place as Lessor may from time to time designate in a written notice to Lessee, and duplicates of all such notices, demands and requests shall similarly be sent to the Assignee. Notices, demands and requests which are served by first class registered mail upon Lessor or Lessee in the manner aforesaid, shall be deemed sufficiently served or given for all purposes hereunder at the time such notice, demand or request shall be mailed by United States first class registered mail as aforesaid in any Post Office or Branch Post Office regularly maintained by the United States Government within the continental limits of the United States.

ARTICLE XXIX

Subordination of Deed of Trust to Lease

Rights of Assignee

Section 29.1. Except as provided in Section 17.4 of the Deed of Trust, the leasehold estate created by this Lease shall constitute a prior encumbrance to the lien of any mortgage or deed of trust now or hereafter placed upon the Property, including the Deed of Trust.

Section 29.2. It is understood and agreed between Lessor and Lessee that all right, title and interest of Lessor in and to this Lease will be assigned by Lessor to the Assignee as additional security for the Note. It is expressly agreed

between Lessor and Lessee that this Lease shall not be terminated (except pursuant to Section 18.1 or Article XX) or surrendered by either the Lessee or the Lessor and neither this Lease nor any provision thereof may be amended in any manner, modified, altered, amended, changed or cancelled without the express written consent of the Assignee. Any attempted termination, surrender, modification, alteration, amendment, change or cancellation otherwise than as permitted in this Section shall be without force and effect and shall be null and void, notwithstanding any express rights of termination, surrender, modification, alteration, amendment, change or cancellation contained in Articles XVII, XVIII, or elsewhere in this Lease except Section 18.1 or Article XX.

SECTION 29.3. Under the terms of the Deed of Trust and of the Assignment to be executed pursuant to the Note Purchase Agreement, Lessor will thereby assign to Assignee as security for the Note all Basic Rent payable hereunder, and Lessee is hereby expressly directed and authorized upon demand of Assignee to pay such Basic Rent pursuant to such Assignment to Assignee in accordance with all the terms, provisions and conditions of this Lease. No Basic Rent shall be prepaid prior to the due date thereof without the prior written consent of Assignee.

ARTICLE XXX

QUIET ENJOYMENT

SECTION 30.1. Lessor covenants and agrees that Lessee, upon paying the Basic Rent and any items of Additional Rent and all other charges herein provided for and observing and keeping the covenants, agreements and conditions of this Lease on its part to be kept, shall lawfully and quietly hold, occupy and enjoy the Property during the term of this Lease without hindrance or molestation of anyone claiming by, through or under Lessor, subject, however, to Permitted Exceptions.

ARTICLE XXXI

DEFINITIONS

SECTION 31.1. As used in this Lease, the following terms have the following respective meanings:

Additional Rent: as defined in Section 4.1.

Assignee: the person, firm, corporation or other entity to which Lessor's interest under this Lease shall at the time have been assigned; unless the context otherwise requires, references to "Lessor or Assignee" shall mean Lessor alone, if no such assignment shall be in effect, and the Assignee and not Lessor if and so long as any such assignment shall be in effect.

Assignment: the assignment by Lessor of its right, title, and interest hereunder to New York Life Insurance Company pursuant to the Note Purchase Agreement.

Basic Rent: as defined in Section 3.1.

Completion Date: as defined in Section 4D of the Note Purchase Agreement.

Construction Contract: the contract between Worthen Bank & Trust Company and Matzon-Bellows, a joint venture, for construction of the Company Improvements.

Deed of Trust: the Deed of Trust to be executed pursuant to the Note Purchase Agreement, constituting a first deed of trust lien on the Property and other property and a present assignment of this Lease and the rents and other sums payable by Lessee hereunder.

Default: any condition or event which constitutes or which, after notice or lapse of time or both, would constitute a default under Article XXV.

Ground Lease: The Ground Lease referred to in Section 1.1.

Improvements: as defined in Section 1.1(a).

Initial Term: as defined in Section 1.2.

Insurance Requirements: all terms of any insurance policy covering or applicable to the Property or any part thereof, all requirements of the issuer of any such policy, and all orders, rules, regulations and other requirements of the National Board of Fire Underwriters (or any other body exercising similar functions) applicable to or affecting the Property or any part thereof or any use or condition of the Property or any part thereof.

Legal Requirements: all laws, statutes, codes, acts, ordinances, orders, judgments, decrees, injunctions, rules regulations, permits, licenses, authorizations, directions and requirements of all governments, departments, commissions, boards, courts, authorities, agencies, officials and officers of governments, Federal, state and municipal, foreseen or unforeseen, ordinary or extraordinary, which now or at any time hereafter may be applicable to the Property or any part thereof, or any of the adjoining sidewalks, streets or ways, or any use or condition of the Property or any part thereof.

Lessee's personal property: all personal property owned by Lessee on or about the Property and excluded from this Lease under Section 1.1 hereof.

Note: as defined in the Note Purchase Agreement.

Note Purchase Agreement: the Note Purchase Agreement, dated as of May 1, 1968, between Lessor and New York Life Insurance Company.

Officer's Certificate: a certificate signed by the President or a Vice President and the Treasurer or an Assistant Treasurer of Lessee and delivered to Lessor and Assignee.

Permitted Exceptions: the items, if any, set forth in Schedule 1 hereto insofar as the same may at the time be in effect and applicable.

Property: as defined in Section 1.1.

Quarterly Installment Dates: as defined in Section 3.3.

Taking: a taking during the term hereof of all or any part of the Property, or any interest therein or right accruing thereto including, without limitation, any right of access thereto existing on the date of this Lease, as the result of or in lieu or in anticipation of the exercise of the right of condemnation or eminent domain, or a change of grade affecting the Property or any part thereof.

Unavoidable Delays: delays due to strikes, acts of God, governmental restrictions, enemy action, civil commotion, fire, unavoidable casualty or other causes beyond the control of Lessee; lack of funds shall not be deemed a cause beyond the control of Lessee.

ARTICLE XXXII

No Merger of Title

SECTION 32.1. There shall be no merger of this Lease nor of the leasehold estate created by this Lease with the fee estate and/or the Ground Lease by reason of the fact that the same person, firm, corporation or other entity may acquire or own or hold, directly or indirectly, (a) this Lease or the leasehold estate created by this Lease or any interest or in any such leasehold estate and (b) the fee estate and/or the Ground Lease or any interest therein, and no such merger shall occur unless and until all persons, corporations, firms and other entities, including each Assignee, having any interest in (i) this Lease or the leasehold estate created by this Lease and (ii) the fee estate and/or the Ground Lease estate shall join in a written instrument effecting such merger and shall duly record the same.

ARTICLE XXXIII

Special Covenants of Lessee

Section 33.1. Lessee hereby agrees to execute the Consent and Agreement referred to in paragraph 41 of the Note Purchase Agreement and to join with Lessor in the execution of a deed of trust dated as of December 1, 1969*, covering (in addition to certain other property of Lessor) Lessee's fee title to Tract A and its land adjacent thereto, as security for the payment of all rent due from Lessee to Lessor and the performance by Lessee of all other obligations required of it under this Building Lease, and also for the purpose of further inducing New York Life Insurance Company to purchase the Note secured, in part, by the Property. Execution of such deed of trust shall never be deemed to make the Lessee liable in any manner, contingent or otherwise, on the indebtedness of Lessor to New York Life Insurance Company unless Lessee shall assume such indebtedness as contemplated in Section 20.2 hereof.

Section 33.2. Lessee hereby agrees to execute a Guaranty to First National City Bank dated May 1, 1968, and to join with Lessor in the execution of a mortgage dated as of May 1, 1968, to First National City Bank covering (in addition to certain other property of Lessor) Lessee's fee title to Tract A and its land adjacent thereto, as security for the payment of all rent due from Lessee to Lessor and the performance by Lessee of all other obligations required of it under this Building Lease, and also for the purpose of further inducing First National City Bank to provide a construction loan to Lessor, secured in part by the Property. Execution of such mortgage shall never be deemed to make Lessee liable in any manner, contingent or otherwise, on the indebtedness of Lessor to First National City Bank upon the construction loan.

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* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

ARTICLE XXXIV

General

Section 34.1. Neither this Lease nor any provision hereof may be changed, waived, discharged or terminated orally, but only by an instrument in writing signed by the party against which enforcement of such change, waiver, discharge or termination is sought. Subject to the provisions hereof, all the terms and provisions of this Lease shall be binding upon and inure to the benefit of and be enforceable by the respective successors and assigns of the parties hereto, and, in particular, shall insure to the benefit of and be enforceable by any Assignee. The table of contents and headings in this Lease are for purposes of reference only and shall not limit or define the meaning hereof. This Lease may be executed in several counterparts, each of which is an original, but all of which shall constitute one instrument.

In Witness Whereof, the parties hereto have caused this Lease to be executed and their respective corporate seals to be hereunto affixed and attested by their respective officer thereunto duly authorized.

Attest:
/s/ M. R. Sadum
Secretary

Frank Lyon Company, *Lessor*
By /s/ C. W. Abrams
President

Attest:
/s/ Booker Worthen
Secretary

Worthen Bank & Trust Company, *Lessee*
By /s/ Edward M. Penick
President

(Acknowledgements Omitted in Printing)

SCHEDULE 1 OF BUILDING LEASE

The land (Tract A) referred to in Section 1.1(a) of the Building Lease, dated as of May 1, 1968, between Frank Lyon Company, Lessor, and Worthen Bank & Trust Company, Lessee, to which this Schedule 1 is attached, consists of a parcel of land in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

BEGINNING at the Southwest corner of Lot 6, Block 84, Original City of Little Rock; thence northerly 160.33 feet along the West side of Lots 6, 5, 4, and 3 to a point 139.67 feet south of the Northwest corner of said Block 84; thence easterly 140.0 feet to a point on the East side of Lot 3, located 139.67 feet South of the Northeast corner of Lot 1; thence 43.88 feet in a southerly direction along the East side of Lots 3 and 4; thence easterly 160.0 feet to a point on the East side of Lot 9, located 116.45 feet North of the Southeast corner of Lot 7; thence southerly 116.45 feet along the East side of Lots 9, 8 and 7, to the Southeast corner of Lot 7; thence westerly 300.0 feet along the South side of Lots 7 and 6 to the point of beginning, LESS AND EXCEPT—

(a) the air space above the North 29.33 feet of Tract A beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the Improvements, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations

thereon, together with the right of ingress and egress for such purposes, provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to Improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

SUBJECT, HOWEVER, to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of City of Little Rock, Arkansas, to Worthen Bank & Trust Company.

FURTHER SUBJECT to liens for unpaid taxes and assessments and to unfiled mechanics' and materialmens' liens.

TABLE A

Option* Date	Purchase Price
12-1-69	$7,889,900.00
3-1-70	$7,871,482.07
6-1-70	$7,852,739.28
9-1-70	$7,833,665.92
12-1-70	$7,814,256.22
3-1-71	$7,794,504.27
6-1-71	$7,774,404.08
9-1-71	$7,753,949.55
12-1-71	$7,733,134.48
3-1-72	$7,711,952.53
6-1-72	$7,690,397.30
9-1-72	$7,668,462.24

* To be adjusted accordingly if the Closing Date of the Note Purchase Agreement shall be other than December 1, 1969.

12-1-72	$7,646,140.74
3-1-73	$7,623,425.98
6-1-73	$7,600,311.09
9-1-73	$7,576,789.08
12-1-73	$7,552,852.81
3-1-74	$7,528,495.04
6-1-74	$7,503,708.38
9-1-74	$7,478,485.32
12-1-74	$7,452,818.25
3-1-75	$7,426,699.38
6-1-75	$7,400,120.82
9-1-75	$7,373,074.52
12-1-75	$7,345,552.31
3-1-76	$7,317,545.85
6-1-76	$7,289,046.68
9-1-76	$7,260,046.18
12-1-76	$7,230,535.59
3-1-77	$7,200,505.99
6-1-77	$7,169,948.31
9-1-77	$7,138,853.30
12-1-77	$7,107,211.59
3-1-78	$7,075,012.61
6-1-78	$7,042,248.63
9-1-78	$7,008,908.77
12-1-78	$6,974,982.97
3-1-79	$6,940,460.99
6-1-79	$6,905,332.43
9-1-79	$6,869,586.68
12-1-79	$6,833,212.95
3-1-80	$6,796,200.29
6-1-80	$6,758,537.53
9-1-80	$6,720,213.32
12-1-80	$6,681,216.10
3-1-81	$6,633,502.18
6-1-81	$6,584,956.01
9-1-81	$6,535,563.14
12-1-81	$6,485,308.87

TABLE A

Option Date	Purchase Price
3-1-82	$6,421,141.74
6-1-82	$6,369,282.80
9-1-82	$6,316,519.56
12-1-82	$6,262,836.34
3-1-83	$6,195,850.29
6-1-83	$6,140,453.40
9-1-83	$6,084,090.79
12-1-83	$6,026,745.63
3-1-84	$5,956,750.01
6-1-84	$5,897,574.92
9-1-84	$5,837,368.41
12-1-84	$5,776,112.55
3-1-85	$5,702,903.85
6-1-85	$5,639,693.93
9-1-85	$5,575,382.46
12-1-85	$5,509,950.34
3-1-86	$5,433,311.40
6-1-86	$5,365,792.67
9-1-86	$5,297,097.54
12-1-86	$5,227,205.62
3-1-87	$5,146,904.64
6-1-87	$5,074,784.59
9-1-87	$5,001,408.23
12-1-87	$4,926,753.78
3-1-88	$4,842,543.39
6-1-88	$4,765,509.77
9-1-88	$4,687,134.51
12-1-88	$4,607,394.35
3-1-89	$4,519,010.56
6-1-89	$4,436,729.97
9-1-89	$4,353,016.64
12-1-89	$4,267,845.73
3-1-90	$4,175,006.80

TABLE A

Option Date	Purchase Price
6-1-90	$4,087,123.33
9-1-90	$3,997,709.86
12-1-90	$3,906,739.87
3-1-91	$3,809,145.14
6-1-91	$3,715,278.83
9-1-91	$3,619,778.68
12-1-91	$3,522,616.37
3-1-92	$3,423,763.09
6-1-92	$3,323,189.54
9-1-92	$3,220,865.88
12-1-92	$3,116,761.82
3-1-93	$3,010,846.49
6-1-93	$2,903,088.42
9-1-93	$2,793,455.87
12-1-93	$2,681,916.27
3-1-94	$2,568,436.58
6-1-94	$2,452,983.21
9-1-94	$2,335,521.96
12-1-94 or thereafter	$2,216,019.91

P. Ex. 20

(Table of Contents Omitted in Printing)

NOTE PURCHASE AGREEMENT

AGREEMENT dated as of May 1, 1968, between FRANK LYON COMPANY, an Arkansas corporation (hereinafter called the Company") and NEW YORK LIFE INSURANCE COMPANY, a New York corporation (hereinafter called "the Purchaser");

W-I-T-N-E-S-S-E-T-H

1. *The Note and the Deed of Trust.* The Company will authorize its 6¾% Secured Note (hereinafter called "the Note") in the principal amount of $7,140,000 to be dated the closing date referred to in paragraph 3, to mature twenty-five (25) years from its date, and to be secured by a Deed of Trust (hereinafter called "the Deed of Trust") and creating, as security for the Note, a first lien upon

A. certain real property in Little Rock, Arkansas, described in the Deed of Trust as Tract A, the Company's interest as lessee in Tract A under the Ground Lease (hereinafter called "Ground Lease") referred to in paragraph 4B hereof and the building, fixtures and improvements (hereinafter called the "Building") now being constructed on Tract A.

B. certain other real property in Little Rock, Arkansas, described in the Deed of Trust as Tract B and the buildings, fixtures and improvements (hereinafter called the "Garage Facility") now being constructed on Tract B (Tracts A and B, the Company's interest as lessee under the Ground Lease, the Building and the Garage Facility being hereinafter collectively called the "Mortgaged Property"), and

C. the Company's interest as lessor in the lease (hereinafter called the "Building Lease") referred to in paragraph 4C hereof.

The Note will also be secured by a separate Assignment (hereinafter called the "Assignment") to be made by the Company to the Purchaser assigning to the Purchaser the Company's interest as lessor in and to the Building Lease.

There are annexed hereto and marked Exhibits A, B, and C, respectively, a form of the Note, a form of the Deed of Trust, and a form of the Assignment, and it is agreed that the Note, the Deed of Trust and the Assignment shall be substantially of the forms of said Exhibits A, B, and C, respectively, subject however, to such changes as shall be mutually agreed upon btween the parties hereto and their respective counsel.

2. *Representations and Warranties:* The Company represents and warrants as follows:

A. The Company is a corporation duly incorporated and validly existing under the laws of the State of Arkansas and is authorized to own property and do business in the State of Arkansas, and is in good standing in said State. The Company has heretofore delivered to the Purchaser copies of the consolidated balance sheets of the Company and its consolidated subsidiaries for the fiscal years ending April 30, 1963, April 30, 1964, December 31, 1964, December 31, 1965, and December 31, 1966, and the related consolidated statements of income and surplus for such fiscal years, all as certified by E. L. Gaunt & Company, independent certified public accountants. Said balance sheets and related statements (including the notes thereto) are correct and complete and truly represent the financial condition of the Company and such subsidiaries as at the respective dates indicated and the results of the operations of the Company and such subsidiaries for the respective periods indicated, and have been prepared in accordance with sound accounting practice consistently maintained throughout the periods indicated. Since December 31, 1966, there have been no material adverse changes in the financial condition of the Company from that set

forth in the balance sheet as at that date and no material adverse changes affecting the operations of the Company. It is agreed that the creation of any indebtedness of the Company to any person, firm or corporation during the period of construction of the Building for the purpose of financing the construction or equipment thereof prior to the issue of the Note and any mortgage, deed of trust or other lien or liens securing the payment of the same does not constitute a material adverse change within the meaning of this Section A or Section G of this paragraph or Section L of paragraph 4 hereof, but it is agreed that any such indebtedness shall be discharged in full on or before the closing date referred to in paragraph 3.

B. The Building is a twenty-four (24) story and single basement, centrally air conditioned, steel, concrete and masonry building with six (6) elevators and about 217,860 feet of net rentable space which is being constructed on Tract A in accordance with the plans and specifications therefor which have been delivered to and approved by the Purchaser. A copy of the construction contract with respect to the Building has been delivered by Worthen Bank & Trust Company (hereinafter called "the Bank") to, and found satisfactory by, the Company. All indebtedness for labor, wages, materials and supplies in connection with such construction of the Building shall have been paid in full, or arrangements therefor shall have been made, prior to the closing date. The estimated costs of such construction of the Building, including fixtures and equipment, is not less than, and the purchase price which is to be paid to the Bank by the Company therefor as reimbursement for such costs is, $7,640,000.

C. There are no material actions, suits or proceedings pending or to the knowledge of the Company threatened against or affecting the Company, or the property of the Company, at law or in equity or before or by any Federal, State, municipal or other governmental department, com-

mission, board, bureau, agency or instrumentality, domestic or foreign (except actions, suits or proceedings of the character normally incident to the kind of business conducted by the Company, which, if adversely determined, would not materially impair the Company's right to carry on its busiess substantially as now conducted or proposed to be conducted); and the Company is not in default with respect to any material order, writ, injunction, decree or demand of any court or Federal, State, municipal or other governmental department, commission, board, bureau, agency or instrumentality.

D. The consummation of the transactions herein contemplated and performance of this Agreement, the Ground Lease, the Building Lease, the Deed of Trust and the Assignment will not result in any breach of, or constitute a default under, any indenture, mortgage, deed of trust, bank loan or credit agreement, corporate charter, by-law or other agreement or instrument to which the Company is a party or by which the Company or the properties of the Company may be bound or affected.

E. Since December 31, 1966, neither the business nor properties of the Company have been materially and adversely affected in any way as a result of any fire, explosion, accident, flood, windstorm, earthquake, strike, lockout, embargo or act of God or the public enemy.

F. The Company is not a "national" of "any designated foreign country" (or a person defined as a "designated foreign country") within the definitions in the Foreign Assets Control Regulations or the Cuban Assets Control Regulations of the United States Treasury Department, 31 C. F. R., Subtitle B, Chapter V, as amended, or any regulation or ruling issued thereunder.

G. The Company is not a party to or bound by any contract made otherwise than in the ordinary course of business and which in the opinion of the Company is a burdensome contract materially and adversely affecting the business, operations or financial condition of the Company.

H. The Company has not, either directly or through any agent, offered the Note or any similar security for sale to, or solicited any offer to buy the Note from, or otherwise approached or negotiated in respect thereof with, any person or persons other than the Purchaser, and the Company agrees that neither it nor any agent on its behalf will sell or offer the Note to, or solicit any offer to buy the Note from, or otherwise approach or negotiate in respect thereof with, any person or persons whomsoever so as thereby to render the issuance and/or sale of the Note a violation of Section 5 of the Securities Act of 1933, as amended.

I. All representations and warranties made by the Company herein and in any certificates delivered pursuant hereto shall survive the execution of the Deed of Trust and the Assignment and sale and delivery of the Note to the Purchaser herein provided for, notwithstanding any inquiry or investigation which the Purchaser may make in respect of the truth or accuracy of such representations and warranties.

3. *Purchase of the Note.* Subject to the terms of this Agreement, the Company hereby agrees to sell to the Purchaser, and the Purchaser agrees to purchase from the Company on such date after the completion of construction of the Building (as defined in paragraph 4D) and the completion of construction of the Garage Facility (except for space in the Building which shall not have been finished for occupancy), but in no event later than December 1, 1969, as the Company shall designate by not less than thirty (30) days notice in writing to the Purchaser, the Note in the principal amount of $7,140,000. The Company agrees that such notice shall be accompanied by certificates itemizing, in detail, the Total Cost of the Building (as defined in para-

graph 4D) and the Total Cost of the Mortgaged Property (as defined in the form of Consent and Agreement annexed hereto and marked Exhibit F) and showing the amounts paid and the amounts remaining to be paid in connection therewith.

Anything herein to the contrary notwithstanding, the Company shall be entitled to defer the closing date for a period not exceeding the lesser of one hundred eighty (180) days or the actual number of days by which construction of the Building shall have been delayed due to strikes, acts of God, governmental restrictions, enemy action, civil commotion, fire, unavoidable casualty or other causes beyond the control of the Company, provided that lack of funds shall not be deemed a cause beyond the control of the Company, and provided further that the Purchaser shall in no event be required to purchase the Note during the period from December 1, 1969 to January 15, 1970.

The Company will make delivery of the Note to the Purchaser by delivering the Note to the Purchaser at the Building, Center and Capitol Streets, Little Rock, Arkansas, against payment therefor in New York funds. The delivery of and payment for the Note as aforesaid are herein referred to as "the closing", and the date thereof as "the closing date".

The Purchaser represents that it is purchasing the Note for its own account, for investment, and not with a view to the distribution thereof, but subject, nevertheless, to the disposition of its property being at all times within its control.

4. *Conditions.* The obligation of the Purchaser to purchase and pay for the Note shall be subject to the following conditions:

A. The Company shall have a good and clear record and marketable title in fee simple absolute to the Building

and an unencumbered leasehold estate under the Ground Lease free and clear of all liens, charges and encumbrances prior to or on a parity with the lien of the Deed of Trust except:

(1) the matters set forth in the granting clause of the Deed of Trust;

(2) Permitted Encumbrances, as defined in Section 1.1 (10) of the Deed of Trust; and

(3) the Building Lease.

B. The Company shall have leased Tract A for a term commencing on or prior to the closing date and ending not less than seventy-five (75) years from the commencement date, substantially in the form and on the terms of Exhibit D hereto annexed, subject, however, to any such changes as shall be mutually agreed upon by the parties hereto and their respective counsel; the Ground Lease shall have been duly filed for record in each proper office in the State of Arkansas and shall be in full force and effect; and such leasing of Tract A shall have been approved by the Housing Authority of the City of Little Rock, Arkansas.

C. The Company shall have leased the Building to the Bank for a term commencing on or prior to, and ending not less than twenty-five (25) years after, the closing date under a Building Lease substantially of the form and terms of Exhibit E hereto annexed, subject, however, to such changes as shall be mutually agreed upon by the parties hereto and their respective counsel; and the Building Lease shall have been duly filed for record in each proper office in the State of Arkansas and shall be in full force and effect.

If the closing shall take place on a date other than December 1, 1969, all of said dates in Exhibit E shall be revised and adjusted appropriately to the mutual satisfaction of the parties.

D. The construction and equipping of the Building shall have been completed in accordance with plans and specifications furnished to and approved by the Purchaser, and all indebtedness for labor, wages, materials and supplies in connection with said construction and equipping shall have been paid in full or arrangements therefor satisfactory to the Purchaser shall have been made. Cotham, Wyman & Howland, Certified Public Accountants, Little Rock, Arkansas, shall have certified to the Purchaser the Total Cost of the Building (as hereinbelow defined) in reasonable detail and the amount thereof shall be at least $7,640,000. The "completion of construction of the Building" shall be established by the delivery to the Purchaser of a certificate (in form and substance satisfactory to the Purchaser) of Erhart, Eichenbaum, Rauch & Blass, Architects, to that effect, and of the certificate of the Housing Authority of the City of Little Rock, Arkansas, required by Paragraph 12 of that certain Contract for Sale of Land (Offer and Acceptance), Central Little Rock Project, ARK R-12, dated September 1, 1966.

For all purposes of this Agreement, "Total Cost of the Building" shall mean the aggregate of the costs reasonably and necessarily incurred and paid by the Company in connection with said construction and equipping of the Building and charged or properly chargeable to the property accounts of the Company in accordance with generally accepted accounting principles, including (but only if and to the extent the same is so charged and chargeable and conforms to such accounting principles) architect's fees and charges for labor, wages, salaries, materials, supplies, superintendence, insurance, accountants' and attorney's fees and expenses, interest on the construction loan, and all other items (other than operating, maintenance or start-up expenses) in connection with such construction and equipping and acquisition and so charged and properly chargeable and conforming to such accounting principles.

Compliance with the provisions of this Subsection shall be established by such certificates of architects, engineers and contractors and officers of the Company as shall be satisfactory in form and substance to the Purchaser. Before accepting any certificates as evidence of the compliance with the provisions of this Subsection, the Purchaser in its discretion may make any further inquiry or investigation into the truth or accuracy of the matters evidenced by any certificate furnished to the Purchaser as it may deem proper. If the Purchaser shall determine to make any such further inquiry or investigation, it shall be entitled to examine the books and records of the Company, personally or by agent or attorney, and unless satisfied with or without such examination of the truth or accuracy of the statements contained in such certificates, it shall be under no obligation to accept such certificates as evidence of such compliance.

E. The Deed of Trust shall have been duly executed and delivered in the form and substance aforesaid; the Deed of Trust or notices or financing statements with respect thereto shall have been duly filed for record in each proper office in the State of Arkansas in which the Deed of Trust or such notices or financing statements should be filed for record and recorded or filed in order to perfect and preserve the lien of the Deed of Trust on the property intended to be covered thereby; prior notice of the Deed of Trust shall have been given to the Housing Authority of the City of Little Rock, Arkansas; the Assignment shall have been duly executed and delivered in form and substance aforesaid; the Assignment shall have been duly filed for record in each proper office in the State of Arkansas in which the Assignment should be filed for record and recorded or filed in order to perfect and preserve the assignment of the Building Lease; all other instruments relating to the issuance and sale of the Note and all proceedings taken on or prior to the closing date in connection with the performance of this Agreement shall be satisfactory

to the Purchaser and its special counsel named in Subsection N of this Section; no Event of Default (as defined in Section 17.1 of the Deed of Trust) shall have occurred (which shall not have been remedied) and no event which, with the lapse of time or with the notice and lapse of time specified in said Section 17.1 would become an Event of Default thereunder shall have occurred which shall not have been remedied; and the Purchaser shall have received copies of all such documents or other evidence as it may reasonably request in order to establish the consummation of such transactions and the taking of all corporate proceedings in connection therewith, in form (as to certification and otherwise) and substance satisfactory to the Purchaser and its said special counsel.

F. The Purchaser shall have received, not less than five (5) days prior to the closing date, a complete set of "as built" plans and specifications for the Building.

G. The Purchaser shall have received a policy or policies of title insurance insuring the interest of the Purchaser in the Mortgaged Property in an aggregate amount at least equal to the principal amount of the Note purchased pursuant to paragraph 3, issued by a title company or title companies, and in form and substance, satisfactory to the Purchaser and its special counsel, covering the Mortgaged Property.

H. The Purchaser shall have received policies of insurance or certified copies thereof or certificates therefor (or other evidence satisfactory to the Purchaser that the below-mentioned insurance has been effected), satisfactory endorsed or written to reflect the Purchaser's interest, issued by insurers of recognized responsibility and in form and amount satisfactory to the Purchaser (but in no event in an amount greater than provided for in the Deed of Trust) covering the risks specified in Subsections A, B (to the extent obtainable) C, D, and E of Section 10.1 of the Deed of Trust.

I. The Consent and Agreement, in the form attached hereto as Exhibit F, shall have been duly authorized, executed and delivered to the Purchaser by the Bank.

J. All representations and warranties in paragraph 2 and in the Consent and Agreement attached as Exhibit F shall (except as affected by transactions contemplated by this Agreement) be true on the closing date with the same effect as though such representations and warranties had been made on and as of the closing date; the Company shall have performed all agreements on its part required to be performed under this Agreement and the Bank shall have performed all agreements required on its part to be performed under the Consent and Agreement on or prior to the closing date; all of the conditions under the Consent and Agreement shall have been fulfilled on or before the closing date; and the Purchaser shall have received a satisfactory certificate or certificates signed by appropriate officers of the Company and/or the Bank, as to all questions of fact involved in the conditions set forth in this Subsection.

K. At the time of the closing, there shall exist no material violations of law or municipal ordinances or orders or requirements of the State of Arkansas, or of any municipal department or other governmental authority having jurisdiction, affecting any of the Mortgaged Property, and the Mortgaged Property shall comply in all material respects with the building restrictions and zoning regulations of the City of Little Rock, Arkansas.

L. The Company shall have delivered to the Purchaser copies of the consolidated balance sheets of the Company and its consolidated subsidiaries for the fiscal years ending December 31, 1967, and December 31, 1968, and the related consolidated statements of income and surplus for such fiscal years, certified by independent certified public accountants. Said balance sheets and related statements (including any notes thereto) shall be correct and

complete and truly represent the financial condition of the Company and such subsidiaries as at the respective dates indicated and the results of the operations of the Company and such subsidiaries for the respective periods indicated, and shall have been prepared in accordance with sound accounting practice consistently maintained throughout the periods indicated. Such balance sheets and related statements shall show no material adverse changes in the financial condition of the Company from that set forth in the balance sheet of the Company as at December 31, 1966, heretofore delivered to the Purchaser and no material adverse changes affecting the operations of the Company.

M. The Purchaser shall have received, not less than five (5) days prior to the closing date, a survey by a surveyor, licensed as such in the State of Arkansas and acceptable to the Purchaser, of Tract A and Tract B, showing the location of all buildings and improvements thereon, duly certified as an accurate survey as of a date not prior to the completion of the construction of the Building and the Garage Facility and not more than twenty (20) days prior to the closing date, and showing no material encroachments, rights of way or easements on Tract A or Tract B or any material encroachments by the buildings or other improvements included in the Mortgaged on adjoining property, except such as may be approved by the Purchaser on or prior to the closing date, and showing no other state of facts which would render the title to the Mortgaged Property unmarketable.

N. The Purchaser shall have received from Messrs. House, Holmes and Jewell, who are acting as special counsel for the Purchaser in connection with this transaction, an opinion in scope and substance satisfactory to the Purchaser, as to,

(1) the due incorporation and existence of the Company and its corporate power to own property and to carry on its business as set forth in paragraph 2A;

(2) the due incorporation and existence of the Bank and its corporate power to own, lease and sublease property and to carry on its business as set forth in the Consent and Agreement;

(3) the due authorization, execution and delivery by the Company of this Agreement and the legality, validity and enforceability as against the Company of this Agreement in accordance with its terms;

(4) the due authorization, execution, and delivery of the Consent and Agreement and as to the legality, validity and enforceability of said Consent and Agreement against the Bank in accordance with its terms;

(5) the due authorization, execution and delivery of the Deed of Trust and the legality, validity and enforceability thereof in accordance with its terms and as to the creation by the Deed of Trust of the lien it purports to create upon the Mortgaged Property and the Company's interest in the Building Lease;

(6) the due authorization, execution and delivery of the Assignment and the legality, validity and enforceability thereof in accordance with its terms;

(7) the due authorization, execution and delivery and issue of the Note and the legality, validity and enforceability thereof in accordance with its terms and the availability to the holder thereof of the benefits and security afforded by the Deed of Trust and the Assignment in accordance with the terms of the Deed of Trust, the Assignment and the Note;

(8) the due authorization, execution and delivery of the Building Lease and the legality, validity and enforceability thereof in accordance with its terms;

(9) the due authorization, execution and delivery of the Ground Lease and the legality, validity and enforceability thereof in accordance with its terms;

(10) the exemption of the issuance, sale and delivery of the Note from the registration requirements of the Securities Act of 1933, as amended, and of the the Trust Indenture Act of 1939, as amended, and the Deed of Trust from the qualification requirements of availability to the Purchaser under existing laws of such exemptions in respect of any resale of the Note by the Purchaser if the Purchaser should in the future deem it expedient to sell the same;

(11) as to the adequacy of the property descriptions contained in the Deed of Trust, the Ground Lease and the Building Lease for the purpose of the Deed of Trust, the Ground Lease and the Building Lease, and the compliance of the form of the Deed of Trust, the Assignment, the Ground Lease and the Building Lease with all applicable laws of the State of Arkansas, including applicable recording laws;

(12) as to the formal approval of the Board of Governors of the Federal Reserve System to the consummation of the transactions contemplated by that certain agreement (hereinafter called the "Sales Agreement") dated as of May 1, 1968 between the Company and the Bank and of the financing and leasing transactions contemplated by this Agreement, or to the effect that no such approval is required;

(13) as to the formal approval of the Arkansas Bank Commissioner to the consummation of the transactions contemplated by the Sales Agreement and of the financing and leasing transactions contemplated by this Agreement, or as to the written ruling of said Commissioner that no such approval is required;

(14) to the effect that the Deed of Trust or notices or financing statements with respect thereto have been duly filed for record and recorded and filed in each proper office in the State of Arkansas in which the

Deed of Trust or such notices and financing statements should be filed and recorded in order to perfect and preserve the lien of the Deed of Trust on the property intended to be covered thereby, that the Assignment has been duly filed for record and recorded and filed in each proper office in the State of Arkansas in which the Assignment should be filed and recorded in order to perfect and preserve the asignment of the Building Lease as provided for in the Assignment, that the Building Lease has been duly filed for record and recorded in each proper office in said State and that all taxes, recording and filing fees and other charges required to be paid in connection therewith or in connection with the issuance of the Note have been paid, and as to the necessity of any periodic or other re-recording, refiling or filing of the Deed of Trust or notice or continuation statements with respect thereto in order to preserve and protect such lien, and as to the necessity of any periodic or other re-recording, refiling or filing of the Assignment in order to preserve and protect the assignment of the Building Lease;

(15) to the effect that upon foreclosure of the lien created by the Deed of Trust and after the expiration of the statutory period of redemption, the Building Lease and the obligations of the lessee thereunder will continue in full force and effect unaffected by such foreclosure and the Purchaser of the Mortgaged Property upon such foreclosure will become the lessor under the Building Lease and will be entitled to exercise all the rights of the lessor thereunder without the necessity of any attornment by the lessee thereunder;

(16) such other matters incident to the transactions hereby contemplated as the Purchaser may reasonably request.

O. The Purchaser shall have received from Messrs. Rose, Meek, House, Barron, Nash & Williamson, counsel for the Company, an opinion in scope and substance satisfactory to the Purchaser and its said special counsel as to all matters specified in Subsection N of this Section, except N(2), N(4), N(11) as it pertains to Trace B, N(12), and N(13).

5. *Recordation.* The Company agrees that, as soon as reasonably possible after the closing, it will, at its own expense, cause to be delivered to said special counsel for the Purchaser official evidence of the recordation and filing of the Deed of Trust and notices or financing statements with respect thereto and the Assignment, the Ground Lease and the Building Lease in the manner specified in the above-mentioned opinion of said special counsel for the Purchaser, showing that all taxes, recording fees and other charges in connection therewith have been paid and showing in reasonable detail the pertinent recordation and filing data. The Company also agrees to re-record, refile or file the Deed of Trust or notices or continuation statements or financing statements with respect thereto wherever necessary in order to preserve and protect the lien of the Deed of Trust, and to re-record, refile or file the Assignment wherever necessary in order to preserve and protect the assignment of the Building Lease as provided for in the Assignment.

6. *Financial Statements and Information.* So long as the Purchaser shall hold the Note, the Company will furnish to the Purchaser as soon as available, and in any event within 120 days after the end of each fiscal year, beginning with the fiscal year ending December 31, 1969, two copies of its balance sheet as of the end of such fiscal year, setting forth in comparative form the corresponding figures as at the end of the previous fiscal year, and two copies of its income and surplus statements for such fiscal year, setting forth in comparative form the corresponding

figures as at the end of the previous fiscal year. Such balance sheets and statements shall be prepared in reasonable detail in accordance with good accounting practice, and shall be accompanied by a report and opinion of independent certified public accountants of recognized standing selected by the Company. Such reports and opinions of such accountants shall include a statement that such accountants, in making the audit necessary for such report, have obtained no knowledge of any default by the Company in the fulfillment of any of the terms, covernants, provisions or conditions of Sections 10.1 and 20.1 of the Deed of Trust, or, if such accountants shall have obtained knowledge of any such default, they shall disclose in such statements the default or defaults and the nature thereof. Such reports of such accountants shall also include such other reports, schedules or information as may be furnished to the Company by such accountants in connection with such audit.

It is understood that the Purchaser shall be free to deliver copies of the financial statements referred to in this Section, as well as any other information or reports furnished to the Purchaser pursuant to this Agreement, to any regulatory body or commission to whose jurisdiction the Purchaser may be subject.

7. *Inspection of Properties and Books.* From the execution and delivery of this Agreement to the closing and thereafter so long as the Purchaser shall hold the aforesaid Note, the Purchaser shall have the right to visit and inspect any of the properties subject to the lien of the Deed of Trust, to examine the books of account of the Company and to discuss the affairs, finances and accounts of the Company with, and to be advised as to the same by, its officers, all at such reasonable times and intervals as the Purchaser may desire.

8. *Expenses.* The Company agrees, whether or not the transactions hereby contemplated shall be consummated, to pay the fees and disbursements of Messrs. House, Holmes

and Jewell for their services to the Purchaser with relation to this Agreement, including the furnishing of the opinions referred to herein and any other transactions, to pay the reasonable expenses of any inquiry or investigation pursuant to paragraph 4D, to pay the charges and expenses in connection with the furnishing of the survey and of the title insurance pursuant to Subsections G and M of paragraph 4, and to pay all printing, filing, recording and other expenses in connection with such transactions, and to reimburse the Purchaser for any out-of-pocket expenses in connection therewith.

9. *Communications.* Except as otherwise expressly provided herein, all communications provided for herein shall be delivered or mailed addressed as follows (or at such other address as may have been furnished in writing to the parties hereto):

To the Company:
Frank Lyon Company
Attention: Mr. Ralph Cotham, Jr.,
Treasurer
6500 Scott Hamilton Drive
Little Rock, Arkansas 72206

To the Purchaser:
New York Life Insurance Company
Attention: Vice-President in Charge
of Real Estate and Mortgage
Loans,
51 Madison Avenue
New York, New York 10010

10. *Brokerage Commission.* The Company agrees to indemnify and hold the Purchaser harmless against any claim for brokerage commission or other such compensation which may be made against the Purchaser by any person, firm or corporation in connection with transactions

hereby contemplated. The Purchaser represents that it has dealt with no person, firm or corporation other than the Company and the Bank in connection therewith.

11. *Successors and Assigns.* All covenants and provisions of this Agreement by or for the benefit of the parties hereto shall bind and inure to the benefit of their respective successors and assigns.

12. *Applicable Law.* This Agreement shall be construed and enforceable in accordance with the laws of the State of Arkansas.

13. *Counterparts.* This Agreements may be executed in any number of counterparts.

In Witness Whereof, the parties hereto have caused this Agreement to be duly executed.

New York Life Insurance Company
By: /s/ Richard W. Bolen, Jr.
Vice President

Frank Lyon Company
By: /s/ C. W. Abrams
President

P. Ex. 21

BUILDING LOAN AGREEMENT

THIS AGREEMENT made this 14th day of May, 1968, between FRANK LYON COMPANY, an Arkansas corporation, having it principal office at West 65th Street and Scott Hamilton Drive, Little Rock, Arkansas (the "Borrower"), and FIRST NATIONAL CITY BANK, a national association, created and existing under the laws of the United States of America, and having a principal office at 399 Park Avenue, Borough of Manhattan, City, County and State of New York (the "Lender");

WITNESSETH:

WHEREAS, on a certain parcel of land located at Center and Capitol Streets, Little Rock, Arkansas (the "Land"), there is to be constructed a 24-story and single basement bank and office building with 6 elevators and about 217,860 square feet of net rentable space ("Worthen Building"), and a separate parking facility ("Parking Facility"); and

WHEREAS, the Borrower has made application to the Lender for a construction loan (the "Loan"), in the principal amount of $7,000,000.00 to assist in the construction of the Worthen Building; and

WHEREAS, Worthen Bank & Trust Company ("Worthen") owns the Land upon which the Worthen Building and the Parking Facility are to be built; and

WHEREAS, Worthen has agreed to sell the Worthen Building to the Borrower as construction procedes; and

WHEREAS, Worthen, as lessor, and the Borrower as lessee, have entered into a lease (the "Ground Lease"), of the land underlying the Worthen Building dated as of May 1, 1968, and recorded in the Circuit Clerk's office of Pulaski County of Arkansas; and

WHEREAS, the Borrower as lessor, and Worthen as lessee, have entered into a lease (the "Building Lease") of the Worthen Building and certain items of equipment installed therein, including a sublease of the land underlying the Worthen Building, dated as of May 1, 1968, and recorded in the Circuit Clerk's office of Pulaski County of Arkansas; and

WHEREAS, the Loan will be evidenced by a note of the Borrower (the "Note" in the form as set forth in Exhibit A hereto) in the amount of SEVEN MILLION DOLLARS ($7,000,000), and will be secured by a first mortgage in like principal amount (the "Mortgage" in the form set forth in Exhibit B hereto) on the fee title of Worthen to the Land and Parking Facility, on the fee title of the Borrower to the Worthen Building and on all right, title and interest of Borrower as lessor under the Building Lease, and as lessee under the Ground Lease (said interests being referred to herein as the "Mortgaged Property" as more fully set forth in the Mortgage); and

WHEREAS, NEW YORK LIFE INSURANCE COMPANY (the "Permanent Lender"), has agreed to purchase a Note to be issued by Borrower on completion of construction of the Worthen Building and the Parking Facility, in the amount of $7,140,000, secured by a Deed of Trust, subject to and in accordance with a certain Note Purchase Agreement of Permanent Lender with the Borrower, dated as of May 1st, 1968 (the "Note Purchase Agreement"); and

WHEREAS, the Lender has agreed to make the Loan to the Borrower as hereinafter provided, and the Borrower agrees to take said Loan and expressly covenants to comply with and perform all of the terms, covenants and conditions of this agreement and Worthen has agreed to construct the Worthen Building in accordance with plans and specifications therefor which have been approved by Lender and Permanent Lender, and the Borrower has agreed to reimburse Worthen for construction costs from

its own funds advanced in connection with the purchase of the Worthen Building.

NOW, THEREFORE, it is agreed between the parties as follows:

1. The Borrower expressly covenants to cause to be erected on the Land the Worthen Building in accordance with the construction contract dated November 8, 1967 between Matson-Bellows and Worthen and with the plans and specifications therefor which, before the making of the first advance hereunder, the Borrower agrees to file or cause to be filed with all governmental authorities having jurisdiction and to obtain or cause to be obtained all necessary approvals of said plans and specifications and all necessary building permits from said authorities. The said plans and specifications have been submitted to and approved by the Lender and Permanent Lender in writing; and no changes or admendments thereto shall be made without first obtaining the written approval of Lender and Permanent Lender.

2. The Note and Mortgage shall contain such clauses as Lender shall determine are needed for the Lender's protection and the Mortgage shall be executed and acknowledged by the Borrower as holder of the fee title to the Worthen Building and of the leasehold estate under the Ground Lease, and by Worthen as the owner of the fee title to the Land and as necessary to make it, as determined by the Lender's attorney, a valid first lien on a good and marketable title to the Mortgaged Property and on the fixtures and personal property to be covered thereby for all sums that may be advanced, free and clear of all liens, encumbrances and effects, except those, if any, to which the Lender has expressly agreed herein to take subject or which the Lender may hereafter waive.

3. The Borrower at the time of the execution of this agreement or, at the option of the Lender, at the time fixed for the delivery of the Mortgage, shall pay all fees and

charges agreed to be paid including but not necessarily limited to the fees and charges for the examination of the title to said premises, surveys, appraisals, inspections and drawing of papers, and Lender's attorney's fee and expenses and shall also pay the recording fees and mortgage recording tax.

4. Advances hereunder will be made no more frequently than once a month, based on certification of Erhart, Eichenbaumm, Rauch & Blass architects (the "architect"), as approved by Lender and Permanent Lender, certifying as to the aggregate percentage of work in place at each stage and of Cotham, Wymman & Howland, certified public accountants, as to the cost of work in place at each stage of construction, and such advances shall be equal to the total certified cost of the work in place less the total of all previous advances hereunder and the amount paid in by Borrower in connection with the construction. In no event shall advances hereunder exceed $7,000,000 in the aggregate.

5. No advance shall be due unless, in the judgment of the Lender, all work done at the stage of construction when the advance is made payable has been done in a good and workmanlike manner, and all materials and fixtures usually furnished and installed at that time have been furnished and installed, and unless all construction be approved by the architect, but the Lender may advance parts or the whole of any installments before they become due, if the Lender believes it advisable so to do, and all such advances or payments shall be deemed to have been made in pursuance of this agreement and not to be modifications thereof. The making of any advance or any part of an advance shall not be deemed an approval or acceptance by the Lender of the work theretofore done. Any advance or installment or any part or parts thereof may be postponed or deferred by mutual consent of the Borrower and the Lender, and any such postponement or postponements shall be deemed to be in pursuance of this agreement and not in modification thereof.

6. The Lender may require five days' notice in writing from the Borrower, before an advance shall be called for. All advances are to be made at the office of the Lender or at such other place and in such manner as the Lender shall designate.

7. The Lender may at any time extend the payment of the principal secured by the Note and Mortgage, and any extensions so granted shall be deemed in pursuance of this agreement and not to be modifications thereof.

8. The Borrower shall furnish or cause to be furnished to the Lender, on or before the making of the final advance, the final certificates of approval, including certificate of occupancy, of the various governmental authorities having jurisdiction and the certificate of the Board of Fire Underwriters acting in and for the locality in which the said premises are situated.

9. The Borrower shall furnish or cause to be furnished to the Lender, or the Lender may procure at the expense of Borrower, surveys made by a surveyor satisfactory to the Lender whenever required by the Lender.

10. The Borrower shall furnish or cause to be furnished to the Lender premiums prepaid, or the Lender may procure at the expense of Borrower, the standard builders risk insurance policies in companies, forms and amounts satisfactory to Lender insuring the premises against loss or damage by fire, with the usual extended coverage endorsement, and other hazards as may reasonably be required by the Lender, and insuring the Lender as first mortgagee.

11. The Lender may at the expense of the Borrower employ a watchman to protect the building and its contents from depredation or injury.

12. If the construction of said building be at any time discontinued or not carried on with reasonable dispatch in the judgment of Lender, said Lender may purchase materials and employ workmen to protect said building so that the same will not suffer from depredation or the weather, or to complete said building so that it may be used for the purposes for which it is designed under the said plans and specifications.

13. All sums paid or expended in accordance with any of the foregoing provisions shall be deemed advanced to the Borrower and secured by the Note and Mortgage and may be applied at the option of the Lender, to any advances thereafter becoming due.

14. The Lender may deduct from any payment to be made under this agreement any amount necessary for the payment of any fees and expenses relating to the examination of the title to said premises, including cost of surveys, charges for appraisals, inspections, drawing of papers, Lender's attorney fees and expenses, mortgage recording tax, revenue stamps, if any, and architects,' engineers' and building loan service fees, and any expenses incurred in the procuring or the making of the Loan, and in the payment of any insurance premiums, mortgage tax, assessment, water rate, sewer rents and other charges, liens and encumbrances upon the said premises whether before or after the making of the Loan and any other amounts necessary for the payment of the cost of improvement and apply such amounts in making said payments, and all sums so applied shall be deemed advances under this agreement and secured by the Note and Mortgage.

15. The Borrower will not assign this contract or the moneys due thereunder or convey or encumber the property without the written consent of the Lender, but in such event the Lender may nevertheless at the option of the Lender, continue to make advances under this Agreement to the Borrower or to those who succeed to the Borrower's title; and all sums so advanced by the Lender shall be deemed advances under this agreement, and not to be modifications thereof, and shall be secured by the Note and Mortgage.

16. The Borrower represents that the Note Purchase Agreement is in full force and effect, and acknowledges that the Lender is relying upon said Note Purchase Agreement in making the Loan and hereby agrees to keep said Note Purchase Agreement in full force and effect and not to agree to any amendments thereto without the written consent of Lender.

17. The Borrower covenants and agrees not to do any act or thing prohibited by the terms of this agreement, and it is expressly agreed that in any of the following events all obligation on the part of the Lender to make said Loan or to make any further advance shall, if the Lender so elects, cease and terminate, and the Note and Mortgage shall, at the option of the Lender become immediately due and payable, but the Lender may make any advances or parts of advances after the happening of any of the following events without thereby waiving the right to demand payment of the mortgage debt and without becoming liable to make any other or further advances:

(a) If the mortgage offered by the Borrower does not give to the Lender a valid first lien on a good and marketable title to the Mortgaged Property and on the fixtures to be covered thereby for all sums that may be advanced, freee and clear of all liens, encumbrances and effects except those, if any, to which the Lender has expressly agreed to take subject or which the Lender may hereafter waive.

(b) If at the time any payment is due to the Borrower the title is not satisfactory to the Lender's attorney, regardless of whether the lien, encumbrances or other question existed at the time of any prior advance.

(c) If the Borrower assigns this contract or any of said advances or any interest therein, or if the property is conveyed or encumbered in any way without the written consent of the Lender.

(d) If a survey shows that the improvement on the Land encroaches upon the street or upon adjoining property, or any adjoining structure encroaches upon the Property to an extent deemed material by the Lender's attorney.

(e) If the Borrower does not take the Loan or the advances within thirty days after they are made payable or if the Note is not paid off in accordance with its terms.

(f) If the improvement on said premises is, in the judgment of the Lender, materially injured or destroyed by fire or otherwise.

(g) If a petition in bankruptcy is filed by or against the Borrower or Worthen or a receiver or trustee of the property of the Borrower or Worthen is appointed; or if the Borrower or Worthen files a petition for reorganization under any of the provisions of the Bankruptcy Act or of any other law, state or federal, or makes an assignment for the benefit of creditors or is adjudged insolvent by any state or federal court of competent jurisdiction, but in no case will an act of insolvency referred to herein on the part of Frank Lyon Company be an event of default hereunder, as long as Worthen assumes the debt hereunder and said assumption is proven to be legally valid to the satisfaction of Lender.

(h) If the Borrower does not make or cause to be made said improvement in accordance with plans and specifications which are previously furnished to and approved in writing by the Lender and Permanent Lender and which have been filed with and approved by all governmental authorities having jurisdiction, and in accordance with all laws, rules, regulations and requirements of such governmental authorities existing at the commencement of the improvement

and any amendments thereof and additions thereto made with the written approval of the Lender and Permanent Lender during the construction of the improvement or fails to file or cause to be filed amended or supplemental plans and specifications, if required, because of such amendments and additions after first obtaining the written approval thereof by the Lender and Permanent Lender and the approval of such governmental authorities; or if the Borrower fails to furnish or cause to be furnished the Lender with a written certificate issued by the department of the governmental authority in the locality in which the property is situated having jurisdiction thereof approving said plans and specifications and any amended and supplemented plans and specifications where such department has jurisdiction.

(i) If the owner of said premises does not permit the Lender, or representatives of the Lender to enter upon said premises and inspect the improvement thereon at all reasonable times and examine all detailed plans, shop drawings and specifications which are kept at work, or fails to furnish to them, when requested, copies of such plans, drawings and specifications.

(j) If for any cause whatever the construction of said improvement is at any time discontinued or not carried on with sufficient dispatch in the judgment of the Lender to complete construction of the Worthen Building on or before the due date for the Building Loan Mortgage Note.

(k) If the Borrower executes any chattel mortgage on any of the following materials, fixtures or articles used in the construction or operation of the improvement or appurtenant thereto, or articles of personal property placed in said premises which are purchased from Worthen Bank by the Borrower, or if any such

materials, fixtures or articles are not satisfactory to the Lender or are purchased on conditional bill of sale or otherwise so that the ownership thereof will not vest unconditionally in the Borrower, free from encumbrance, on delivery at the premises; and if the Borrower does not furnish to the Lender, if requested, the contracts, bills of sale, statements, receipted vouchers and agreements, or any of them, under which the Borrower claims title to such materials, fixtures and articles.

(l) If the Borrower fails to comply with any requirement of any governmental authority having jurisdiction within thirty days after notice in writing of such requirement shall have been given to said Borrower; or fails to furnish to the Lender, when requested, official searches made by the governmental authorities having jurisdiction.

(m) If the Borrower does not disclose or cause to be disclosed to the Lender, upon demand, the names of all persons with whom the Borrower or Worthen has contracted or intends to contract for the construction of said improvement or the furnishing of labor or materials therefor.

(n) If the Borrower permits any purchaser or prospective purchaser to occupy the premises before this agreement shall have been fully performed and the final advance made thereunder.

(o) If the Borrower fails to keep, observe or perform any of the conditions, stipulations, agreements or covenants contained in this agreement or in the Note or Mortgage.

18. And it is mutually understood and agreed by and between the parties hereto on behalf of themselves and their respective personal representatives or successors in interest that the Note and Mortgage contemplated to be

executed, acknowledged and delivered pursuant to this agreement shall be made subject to all conditions, stipulations, agreements and covenants contained in this agreement, to the same extent and effect as they would be if fully set forth in and made part of the Note and Mortgage, until this agreement is terminated by the completion of the improvement described herein and the making of the final advance hereunder as provided for herein; and it is further expressly understood and agreed that this agreement is made subject to all conditions, stipulations, agreements and convenants contained in the Note and Mortgage, to the same extent and effect as they would be if fully set forth herein and made part hereof.

This agreement may not be changed or terminated orally. Whenever the word "Lender" is used herein it shall be deemed to include also the personal representatives, successors and assigns of the Lender.

In Witness Whereof, the parties hereto have duly executed this agreement the day and year first above written.

Attest:	Frank Lyon Company
/s/ M. R. Godwin	By /s/ C. W. Abrams
	President
/s/ Frank R. Guy	First National City Bank
Assistant Cashier	By /s/ Illegible
	Vice President

(Acknowledgments Omitted in Printing)

EXHIBIT A

Building Loan Mortgage Note

$7,000,000.00 — Little Rock, Arkansas
May , 1968

For Value Received, Frank Lyon Company, an Arkansas corporation, with its principal office and place of business at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas, promises to pay to First National City Bank, a national banking association, created and existing under the laws of the United States of America, and having an office at No. 399 Park Avenue, Borough of Manhattan, City, County and State of New York, or order at 399 Park Avenue, New York, New York 10022, or at such other place as may be designated in writing by the holder of this note, the principal sum of Seven Million Dollar: ($7,000,000.00), or so much thereof as may be advanced, on the earlier of the following dates: (a) December 1, 1969, or (b) the date on which this loan will be funded by funds from the loan to be made by New York Life Insurance Company to maker herein, pursuant to its Note Purchase Agreement with Frank Lyon Company dated May 1, 1968, with interest thereon to be computed from the date of each advance at a rate equal to Lender's current best rate for commercial borrowing, said interest rate being subject to change on written notice from Lender, said change to become effective as of the first day of the month following the month in which such rate change was effected. Said interest is to be paid on the first day of June, 1968, and on the first day of each month thereafter until maturity, at which time all unpaid principal and interest shall become immediately due and payable.

It Is Hereby Expressly Agreed, that the said principal sum secured by this note shall, at the option of the holder thereof, become due on the happening of any default or

event by which, under the terms of the mortgage securing this note or of the building loan agreement mentioned in said mortgage, said principal sum may or shall become due and payable; also, that all of the covenants, conditions and agreements contained in said mortgage and building loan agreement are hereby made part of this instrument.

It Is Further Expressly Agreed, that advances are to be made here under as provided in said building loan agreement and that the indebtedness hereunder will not exceed the amount actually disbursed by First National City Bank.

Presentment for payment, notice of dishonor, protest and notice of protest are hereby waived.

This note is secured by a mortgage made by the maker to the payee of even date herewith, on property situate at Center and Capitol Streets, Little Rock, Arkansas, as more fully described in said mortgage.

This note may not be changed or terminated orally.

Frank Lyon Company

By .....
President

(Acknowledgment Omitted in Printing)

EXHIBIT B

Building Loan Mortgage

This Mortgage, made the 14th day of May, nineteen hundred and sixty-eight, between Frank Lyon Company, an Arkansas corporation, with its principal office and place of business at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas (the "Frank Lyon Company"), and Worthen Bank & Trust Company, an Arkansas banking corporation with its principal office and place of business at Fourth and Main Streets, Little Rock, Arkansas ("Worthen") (The Frank Lyon Company and Worthen being hereinafter sometimes collectively called the "mortgagor"), and First National City Bank, a national banking association, created and existing under the laws of the United States of America, and having an office at No. 399 Park Avenue, Borough of Manhattan, City, County and State of New York (the "mortgagee").

Witnesseth, that to secure the payment of an indebtedness in the sum of Seven Million ($7,000,000.00) Dollars, lawful money of the United States or so much thereof as may be advanced, to be paid according to a certain note executed and delivered by the Frank Lyon Company to mortgagee bearing even date herewith, the Frank Lyon Company to mortgagee bearing even date herewith, the Frank Lyon Company hereby mortgages to the mortgagee the following properties (which are hereinafter sometimes collectively called the "Company Property"):

(a) all buildings, structures and other improvements now or hereafter located on certain real property hereinafter referred to as "Tract A" and described in Schedule I hereto, together with all fixtures now or hereafter attached to or located thereon (collectively, "Company Improvements"), subject to the Building Lease described below, and

(b) all right, title and interest of the Frank Lyon Company as Lessor in, to and under that certain lease dated as of May 1, 1968 (the "Building Lease"), between the Frank Lyon Company as Lessor and Worthen as Lessee covering, among other things, the Company Improvements together with rentals payable thereunder, and

(c) all right, title and interest of the Frank Lyon Company as Lessee in, to and under that certain lease dated as of May 1, 1968 (the "Ground Lease"), between Worthen as Lessor and the Frank Lyon Company as Lessee, covering Tract A.

And Worthen Hereby Mortgages to the Mortgagee the following properties (collectively, "Bank Property"):

(a) Tract A, subject to Ground Lease, and

(b) certain real property hereinafter referred to as "Tract B" and described in Schedule II hereto, together with all buildings, structures and other improvements now or hereafter located thereon (collectively, the "Parking Facility").

And Frank Lyon Company and/or Worthen covenant with the mortgagee as follows:

1. That the Frank Lyon Company will pay the indebtedness as hereinbefore provided.

2. That all awards heretofore or hereafter made to the mortgagor for taking by eminent domain the whole or any part of said premises or any easement therein, including any awards for changes of grade of streets are hereby assigned to the mortgagee, who is hereby authorized to collect and receive the proceeds of such awards and to give proper receipts and acquittances therefor; and to apply the same toward the payment of the mortgage debt, including interest at the rate paid by condemning authority or at the

rate payable hereunder whichever rate shall be higher; notwithstanding the fact that the amount owing thereon may not then be due and payable; and the said mortgagor hereby agrees, upon request, to make, execute and deliver any and all assignments and other instruments sufficient for the purpose of assigning said awards to the mortgagee, free, clear and discharged of any encumbrances of any kind or nature whatsoever.

3. Mortgagor will keep all buildings, improvements, fixtures and articles of personal property constituting any part of the Mortgaged Property insured against loss or damage by fire and such other risks as shall be insurable under standard forms of fire and extended coverage insurance policies, against war damage (whenever such war damage insurance shall be available and shall be required by mortgagee), and against such other hazards, casualties, contingencies and risks of loss or damage as mortgagee from time to time may require (provided that insurance against such other risks shall then be commonly carried by prudent owners of office buildings in the City of Little Rock, Arkansas), and will keep on deposit with mortgagee policies, in amounts and in form, and issued by insurers satisfactory to mortgagee, evidencing such insurance and providing that loss payable thereunder shall be paid to mortgagee as interest may appear in accordance with a standard mortgagee clause acceptable to mortgagee and made a part of each policy, and, at least ten (10) days prior to the expiration of any existing policy, will deposit with mortgagee a policy replacing such expiring policy, which new policy, to the extent that provision for payment of the premiums therefor has not hereinabove been made, shall be accompanied by evidence satisfactory to mortgagee of payment of premiums. In the even of loss or damage, mortgagor will give mortgagee immediate notice thereof in writing, and mortgagee shall have the right to make proof of loss, if not made promptly by mortgagor. At the option of mortgagee, the proceeds of loss under any

policy may be applied, either in whole or in part, after deducting all costs of collection, including reasonable attorneys' fees, in payment of the indebtedness hereby secured, whether due or not, or to the reconstruction, restoration or repair of the premises. Mortgagor's interest in all such policies is hereby assigned and transferred to mortgagee and, in the event of the transfer of title to the premises by foreclosure, power of sale or otherwise, all right, title and interest of mortgagor in and to such policies, with sole right to collect all unearned premiums thereon, shall pass to the purchaser or grantee.

4. That no building on the premises shall be altered, removed or demolished without the consent of the mortgagee other than as shown on approved plans and specifications.

5. That the whole of said principal sum and interest shall become due at the option of the mortgagee; after default in the payment of any installment for fifteen (15) days; or any tax, water rate, sewer rent or assessment for thirty (30) days after the notice and demand; or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire or in reimbursing the mortgagee for premiums paid on such insurance, as hereinbefore provided; or after default upon request in furnishing a statement of the amount due on the mortgage and whether any offsets or defenses exist against the mortgage debt, as hereinafter provided. An assessment which has been made payable in installments at the application of the Frank Lyon Company or lessee of the premises shall nevertheless, for the purpose of this paragraph, be deemed due and payable in its entirety on the day the first installments becomes due or payable or a lien.

6. That the holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver.

7. That the mortgagor will pay all taxes, assessments, sewer rents or water rates, and in default thereof, the mortgagee may pay the same.

8. That the Frank Lyon Company within five (5) days, upon request in person, or within ten (10) days, upon request by mail, will furnish a written statement duly acknowledged of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.

9. That notice and demand or request may be in writing and may be served in person or by mail.

10. That at the time of the ensealing and delivery of this mortgage, mortgagor is well seized of the Mortgaged Property to the extent of the respective interests of Frank Lyon Company and Worthen hereinabove set forth and has good right, full power and lawful authority to grant, bargain, sell, convey and encumber the same in manner and form aforesaid, and that the same are free and clear of any mortgage, lien, charge or encumbrance, except easements of record, and that mortgagor will forever warrant and defend title to the Mortgaged Property against the claims and demands of all persons whomsoever.

11. That upon any foreclosure sale, the Mortgaged Property may be sold either as a whole or in parcels as mortgagee may elect and mortgagor hereby waives any right to require any such sale to be made in parcels. Upon any foreclosure sale, the fee simple and leasehold estates described herein may also be sold either as a whole or separately, as mortgagee may elect, and mortgagor hereby waiver any right to require any such sale of said estates separately.

12. That if any action or proceeding be commenced (except an action to foreclose this mortgage or to collect the debt secured thereby), to which action or proceeding the mortgagee is made a party, or in which it becomes

necessary to defend or uphold the lien of this mortgage, all sums paid by the mortgagee for the expense of any litigation to prosecute or defend the rights and lien created by this mortgage (including reasonable counsel fees), shall be paid by Frank Lyon Company, together with interest thereon at the rate of six (6%) percent per annum, and any such sum and interest thereon shall be a lien on said premises, prior to any right, or title to, interest in or claim upon said premises attaching or accruing subsequent to the lien of this mortgage, and shall be deemed to be secured by this mortgage. In any action or proceeding to foreclose this mortgage, or to recover or collect the debt secured thereby, the provisions of law respecting the recovering of costs, disbursements and allowances shall prevail unaffected by this covenant.

13. That the Frank Lyon Company hereby assigns to the mortgagee the rents, issues and profits of the premises as further security for the payment of said indebtedness, and the Frank Lyon Company grants to the mortgagee the right to enter upon and take possession of the premises for the purpose of collecting the same and to let the premises or any part thereof, and to apply the rents, issues and profits, after payment of all necessary charges and expenses, on account of said indebtedness. This assignment and grant shall continue in effect until this mortgage is paid. The mortgagee hereby waives the right to enter upon and take possession of said premises for the purpose of collecting said rents, issues and profits, and Frank Lyon Company shall be entitled to collect and receive said rents, issues and profits until default under any of the covenants, conditions or agreements contained in this mortgage, and agrees to use such rents, issues and profits in payment of principal and interest becoming due on this mortgage and in payment of taxes, assessments, sewer rents, water rates and carrying charges become due against said premises, but such right of Frank Lyon Company may be revoked by the mortgagee upon any default,

on five days' written notice. Frank Lyon Company will not, without the written consent of the mortgagee, receive or collect rent from any tenant of said premises or any part thereof for a period of more than one month in advance, and in the event of any default under this mortgage will pay monthly in advance to the mortgagee, or to any receiver appointed to collect said rents, issues and profits, the fair and reasonable rental value for the use and occupation of said premises or of such part thereof as may be in the possession of Frank Lyon Company, and upon default in any such payment will vacate and surrender the possession of said premises to the mortgagee or to such receiver, and in default thereof may be evicted by summary proceedings.

14. That the whole of said principal sum and the interest shall become due at the option of the mortgagee: (a) after failure to exhibit to the mortgagee, within ten days after demand, receipts showing payment of all taxes, water rates, sewer rents and assessments; or (b) after the actual or threatened alteration, demolition or removal of any building on the premises without the written consent of the mortgagee; or (c) after the assignment of the rents of the premises or any part thereof without the written consent of the mortgagee; or (d) if the buildings on said premises are not maintained in reasonably good repair; or (e) after failure to comply with any requirement or order or notice of violation of law or ordinance issued by any governmental department claiming jurisdiction over the premises within three months from the issuance thereof; or (f) if mortgagor does not furnish adequate fire insurance coverage, and if on application of the mortgagee two or more fire insurance companies lawfully doing business in the State of Arkansas refuse to issue policies insuring the buildings on the premises; or (g) in the event of the removal, demolition or destruction in whole or in part of any of the fixtures, chattels or articles of personal property covered hereby, unless the same are promptly re-

placed by similar fixtures, chattels and articles of personal property at least equal in quality and condition to those replaced, free from chattel mortgages or other encumbrances thereon and free from any reservation of title thereto; or (h) if the mortgagor fails to keep, observe and perform any of the other covenants, conditions or agreements contained in this mortgage or of those contained in the building loan contract hereinafter mentioned.

15. This mortgage is made pursuant to a certain building loan agreement between the Frank Lyon Company and the mortgagee dated May 14, 1968, and intended to be filed in the office of the Clerk of the County of Pulaski on or before the date of the recording of this mortgage, and is subject to all the provisions of said contract as if they were fully set forth herein and made part of this mortgage.

16. That without the consent of the mortgagee, Frank Lyon Company will not, and shall not have the right or power to, cancel, abridge, terminate or otherwise modify tenancies, subtenancies, leases or subleases of the premises, and that Frank Lyon Company will not accept prepayments of instalments of rent to become due thereunder.

17. That the execution of this mortgage has been authorized by the board of directors of Frank Lyon Company and Worthen.

18. That within thirty (30) days after notice and demand, the Frank Lyon Company will deliver to the mortgagee a certified current financial statement in form satisfactory to mortgagee.

19. That there shall be no merger of the lease described herein, or of the leasehold estate created thereby, with the fee estate described therein by reason of the fact that said lease or the leasehold estate created thereby may be held by or for the account of any person or persons who shall be the owner or owners of said fee estate, unless and until all persons including mortgagee at the time having an interest in said fee estate or in said lease shall join in

a written instrument declaring a contrary intent and shall duly record the same.

20. Pursuant to Section 33.2 of the lease of the Mortgaged Property between Frank Lyon Company as Lessor and Worthen as Lessee Worthen joins herein for the sole purpose of subjecting and binding all of its title, right, interest and estate in and to the Mortgaged Property to the full and faithful performance and observance of all of the terms, covenants and conditions of this mortgage. Nothing contained herein or in the note hereby secured shall be construed as obligating Worthen to pay any sums required to be paid hereunder or thereunder. Mortgagee, by accepting this mortgage, specifically concurs in the statements contained in this paragraph.

This mortgage may not be changed or terminated orally. The covenants contained in this mortgage shall run with the land and bind the mortgagor, the heirs, personal representatives, successors and assigns of the mortgagor and all subsequent owners, encumbrancers, tenants and subtenants of the premises, and shall enure to the benefit of the mortgagee, the personal representatives, successors and assigns of the mortgagee and all subsequent holders of this mortgage. The word "mortgagor" shall be construed as if it read "mortgagors" and the word "mortgagee" shall be construed as if it read "mortgagees" whenever the sense of this mortgage so requires.

IN WITNESS WHEREOF, this mortgage has been duly executed by the mortgagor.

ATTEST:

FRANK LYON COMPANY

..... By .....
President

WORTHEN BANK & TRUST COMPANY

..... By .....
President

(Acknowledgments Omitted in Printing)

SCHEDULE I

The land (Tract A) referred to in the Mortgaging Clause applicable to Frank Lyon Company of the Mortgage dated as of May 14, 1968, between Worthen Bank & Trust Company and Frank Lyon Company as Mortgagors and First National City Bank as Mortgagee, to which this Schedule I is attached, consists of a parcel in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

BEGINNING at the Southwest corner of Lot 6, Block 84, Original City of Little Rock; thence northerly 160.33 feet along the West side of Lots 6, 5, 4 and 3 to a point 139.67 feet South of the Northwest corner of said Block 84; thence easterly 140.0 feet to a point on the East side of Lot 3, located 139.67 feet South of the Northeast corner of Lot 1; thence 43.88 feet in a southerly direction along the East side of Lots 3 and 4; thence easterly 160.0 feet to a point on the East side of Lot 9, located 116.45 feet North of the Southeast corner of Lot 7; thence southerly 116.45 feet along the East side of Lots 9, 8 and 7 to the Southeast corner of Lots 7; thence westerly 300.0 feet along the South side of Lots 7 and 6 to the point of beginning;

SUBJECT, however, to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of The City of Little Rock, Arkansas, to Worthen Bank & Trust Company;

FURTHER SUBJECT to liens for unpaid taxes and assessments and to unfiled mechanics' and materialmens' liens;

LESS AND EXCEPT—

(a) the air space above the North 29.33 feet of Tract A beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

SCHEDULE II

The land (Tract B) referred to in the Mortgaging Clause applicable to Worthen Bank & Trust Company of the Mortgage dated as of May 14, 1968, between Frank Lyon Company and Worthen Bank & Trust Company as Mortgagors and First National City Bank as Mortgagee, to which this Schedule II is attached, consists of a parcel of land in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

BEGINNING at the Northwest corner of Lot 1, Block 84, Original City of Little Rock; thence easterly 140.0 feet along the North side of Lot 1 to the Northeast corner of Lot 1; thence southerly 139.67 feet along the East side of Lots 1, 2, and 3; thence westerly 140.0 feet to

a point on the West side of Lot 3, located 139.67 feet South of the Northwest corner of Lot 1, thence northerly 139.67 feet along the west side of Lots 3, 2 and 1 to the point of beginning;

SUBJECT HOWEVER, To a perpetual surface easement for use by the public as a passageway, described in an Agreement between Worthen Bank & Trust Company and Union National Bank of Little Rock, Trustee and Charles M. Taylor, Trustee, dated April 14, 1967, and recorded July 5, 1967, in Book 1001 at Pages 187-194, inclusive, of the records of the Circuit Clerk of Pulaski County, Arkansas, and further described in an Agreement dated July 26, 1967, filed for record August 2, 1967, and recorded in Book 1004 at Page 515 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by and between Worthen Bank & Trust Company and Union National Bank of Little Rock and William L. Terry, as Co-Trustees under "The Terry Trust," and Adolphine Fletcher Terry, said easement covering the north 20 feet of the South 25.17 feet of Tract B plus the turning radius described in said Agreement.

FURTHER SUBJECT to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of City of Little Rock, Arkansas, to Worthen Bank & Trust Company.

FURTHER SUBJECT to liens for unpaid taxes and assessments and to unfiled merchanics' and materialmens' liens.

TOGETHER WITH—

(a) the air space above the North 29.33 feet of Tract A (described in Schedule I hereof) beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

P. Ex. 22

BUILDING LOAN MORTGAGE NOTE

$7,000,000.00 — Little Rock, Arkansas
May 14, 1968

FOR VALUE RECEIVED, FRANK LYON COMPANY, an Arkansas corporation, with its principal office and place of business at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas, promises to pay to FIRST NATIONAL CITY BANK, a national banking association, created and existing under the laws of the United States of America, and having an office at No. 399 Park Avenue, Borough of Manhattan, City, County and State of New York, or order at 399 Park Avenue, New York, New York 10022, or at such other place as may be designated in writing by the holder of this note, the principal sum of SEVEN MILLION DOLLARS ($7,000,000.00), or so much thereof as may be advanced, on the earlier of the following dates: (a) December 1, 1969, or (b) the date on which this loan will be funded by funds from the loan to be made by New York Life Insurance Company to maker herein, pursuant to its Note Purchase Agreement with Frank Lyon Company dated as of May 1, with interest thereon to be computed from the date of each advance at a rate equal to Lender's current best rate for commercial borrowing, said interest rate being subject to change on written notice from Lender, said change to become effective as of the first day of the month following the month in which such rate change was effected. Said interest is to be paid on the first day of June, 1968, and on the first day of each month thereafter until maturity, at which time all unpaid principal and interest shall become immediately due and payable.

IT IS HEREBY EXPRESSLY AGREED, that the said principal sum secured by this note shall, at the option of the holder thereof, become due on the happening of any default or event by which, under the terms of the mortgage securing this note or of the building loan agreement mentioned in

said mortgage, said principal sum may or shall become due and payable; also, that all of the covenants, conditions and agreements contained in said mortgage and building loan agreement are hereby made part of this instrument.

IT IS FURTHER EXPRESSLY AGREED, that advances are to be made hereunder as provided in said building loan agreement and that the indebtedness hereunder will not exceed the amount actually disbursed by First National City Bank.

Presentment for payment, notice of dishonor, protest and notice of protest are hereby waived.

This note is secured by a mortgage made by the maker to the payee of even date herewith, on property situate at Center and Capitol Streets, Little Rock, Arkansas, as more fully described in said mortgage.

This note may not be changed or terminated orally.

FRANK LYON COMPANY

By /s/ C. W. ABRAM
President

(Acknowledgment Omitted in Printing)

P. Ex. 23

No. 31348 Filed For Record May 14, 1968, at 3:05 o'clock p.m. (SEAL) and recorded May 15, 1968. ROGER MCNAIR, CLERK.

BUILDING LOAN MORTGAGE

THIS MORTGAGE, made the 14th day of May, nineteen hundred and sixty-eight, between FRANK LYON COMPANY, an Arkansas corporation, with its principal office and place of business at West Sixty-fifth Street and Scott Hamilton Drive, Little Rock, Arkansas (the "Frank Lyon Company"), and WORTHEN BANK & TRUST COMPANY, an Arkansas banking corporation with its principal office and place of business at Fourth and Main Streets, Little Rock, Arkansas ("Worthen") (The Frank Lyon Company and Worthen being hereinafter sometimes collectively called the "mortgagor"), and FIRST NATIONAL CITY BANK, a national banking association, created and existing under the laws of the United States of America, and having an office at No. 399 Park Avenue, Borough of Manhattan, City, County and State of New York (the "mortgagee").

WITNESSETH, that to secure the payment of an indebtedness in the sum of SEVEN MILLION ($7,000,000.00) DOLLARS, lawful money of the United States or so much thereof as may be advanced, to be paid according to a certain note executed and delivered by the Frank Lyon Company to mortgagee bearing even date herewith, the Frank Lyon Company hereby mortgages to the mortgagee the following properties (which are hereinafter sometimes collectively called the "Company Property"):

(a) all buildings, structures and other improvements now or hereafter located on certain real property hereinafter referred to as "Tract A" and described in Schedule I hereto, together with all fixtures now or hereafter attached to or located thereon

(collectively, "Company Improvements"), subject to the Building Lease described below, and

This instrument prepared by:

Wright, Lindsay and Jennings
Attorneys at Law
Little Rock, Arkansas.

(b) all right, title and interest of the Frank Lyon Company as Lessor in, to and under that certain lease dated as of May 1, 1968 (the "Building Lease"), between the Frank Lyon Company as Lessor and Worthen as Lessee covering, among other things, the Company Improvements together with rentals payable thereunder, and

(c) all right, title and interest of the Frank Lyon Company as Lessee in, to and under that certain lease dated as of May 1, 1968 (the "Ground Lease"), between Worthen as Lessor and the Frank Lyon Company as Lessee, covering Tract A.

AND WORTHEN HEREBY MORTGAGES TO THE MORTGAGEE the following properties (collectively, "Bank Property"):

(a) Tract A, subject to the Ground Lease, and

(b) certain real property hereinafter referred to as "Tract B" and described in Schedule II hereto, together with all buildings, structures and other improvements now or hereafter located thereon (collectively, the "Parking Facility").

AND Frank Lyon Company and/or Worthen covenant with the mortgagee as follows:

1. That the Frank Lyon Company will pay the indebtedness as hereinbefore provided.

2. That all awards heretofore or hereafter made to the mortgagor for taking by eminent domain the whole or any

part of said premises or any easement therein, including any awards for changes of grade of streets are hereby assigned to the mortgagee, who is hereby authorized to collect and receive the proceeds of such awards and to give proper receipts and acquittances therefor, and to apply the same toward the payment of the mortgage debt, including interest at the rate paid by condemning authority or at the rate payable hereunder whichever rate shall be higher, notwithstanding the fact that the amount owing thereon may not then be due and payable; and the said mortgagor hereby agrees, upon request, to make, execute and deliver any and all assignments and other instruments sufficient for the purpose of assigning said awards to the mortgagee, free, clear and discharged of any encumbrances of any kind or nature whatsoever.

3. Mortgagor will keep all buildings, improvements, fixtures and articles of personal property constituting any part of the Mortgaged Property insured against loss or damage by fire and such other risks as shall be insurable under standard forms of fire and extended coverage insurance policies, against war damage (whenever such war damage insurance shall be available and shall be required by mortgagee), and against such other hazards, casualties, contingencies and risks of loss or damage as mortgagee from time to time may require (provide that insurance against such other risks shall then be commonly carried by prudent owners of office buildings in the City of Little Rock, Arkansas), and will keep on deposit with mortgagee policies, in amounts and in form, and issued by insurers satisfactory to mortgagee, evidencing such insurance and providing that loss payable thereunder shall be paid to mortgagee as interest may appear in acordance with a standard mortgage clause acceptable to mortgagee and made a part of each policy, and, at least ten (10) days prior to the expiration of any existing policy, will deposit with mortgagee a policy replacing such expiring policy, which new policy, to the extent that provision for payment

of the premiums therefor has not hereinabove been made, shall be accompanied by evidence satisfactory to mortgagee of payment of premiums. In the event of loss or damage, mortgagor will give mortgagee immediate notice thereof in writing, and mortgagee shall have the right to make proof of loss, if not made promptly by mortgagor. At the option of mortgagee, the proceeds of loss under any policy may be applied, either in whole or in part, after deducting all costs of collection, including reasonable attorneys' fees, in payment of the indebtedness hereby secured, whether due or not, or to the reconstruction, restoration or repair of the premises. Mortgagor's interest in all such policies is hereby assigned and transferred to mortgagee and, in the event of the transfer of title to the premises by foreclosure, power of sale or otherwise, all right, title and interest of mortgagor in and to such policies, with sole right to collect all unearned premiums thereon, shall pass to the purchaser or grantee.

4. That no building on the premises shall be altered, removed or demolished without the consent of the mortgagee other than as shown on approved plans and specifications.

5. That the whole of said principal sum and interest shall become due at the option of the mortgagee: after default in the payment of any instalment of interest for fifteen (15) days; or after default in the payment of any tax, water rate, sewer rent or assessment for thirty (30) days after the notice and demand; or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire or in reimbursing the mortgagee for premiums paid on such insurance, as hereinbefore provided; or after default upon request in furnishing a statement of the amount due on the mortgage and whether any offsets or defenses exist against the mortgage debt, as hereinafter provided. An assessment which has been made payable in instalments at the application of the Frank Lyon Company or lessee of

the premises shall nevertheless, for the purposes of this paragraph, be deemed due and payable in its entirety on the day the first instalments become due or payable or a lien.

6. That the holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver.

7. That the mortgagor will pay all taxes, assessments, sewer rents or water rates, and in default thereof, the mortgagee may pay the same.

8. That the Frank Lyon Company within five (5) days, upon request in person, or within ten (10) days, upon request by mail, will furnish a written statement duly acknowledged of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.

9. That notice and demand or request may be in writing and may be served in person or by mail.

10. That at the time of the ensealing and delivery of this mortgage, mortgagor is well seized of the Mortgaged Property to the extent of the respective interests of Frank Lyon Company and Worthen hereinabove set forth and has good right, full power and lawful authority to grant, bargain, sell, convey and encumber the same in manner and form aforesaid, and that the same are free and clear of any mortgage, lien, charge or encumbrance, except easements of record, and that mortgagor will forever warrant and defend title to the Mortgaged Property against the claims and demands of all persons whomsoever.

11. That upon any foreclosure sale, the Mortgaged Property may be sold either as a whole or in parcels as mortgagee may elect and mortgagor hereby waives any right to

require any such sale to be made in parcels. Upon any foreclosure sale, the fee simple and leasehold estates described herein may also be sold either as a whole or separately, as mortgagee may elect, and mortgagor hereby waives any right to require any such sale of said estates separately.

12. That if any action or proceeding be commenced (except an action to foreclose this mortgage or to collect the debt secured thereby), to which action or proceeding the mortgagee is made a party, or in which it becomes necessary to defend or uphold the lien of this mortgage, all sums paid by the mortgagee for the expense of any litigation to prosecute or defend the rights and lien created by this mortgage (including reasonable counsel fees), shall be paid by Frank Lyon Company, together with interest thereon at the rate of six (6%) percent per annum, and any such sum and interest thereon shall be a lien on said premises, prior to any right, or title to, interest in or claim upon said premises attaching or accruing subsequent to the lien of this mortgage, and shall be deemed to be secured by this mortgage. In any action or proceeding to foreclose this mortgage, or to recover or collect the debt secured thereby, the provisions of law respecting the recovering of costs, disbursements and allowances shall prevail unaffected by this covenant.

13. That the Frank Lyon Company hereby assigns to the mortgagee the rents, issues and profits of the premises as further security for the payment of said indebtedness, and the Frank Lyon Company grants to the mortgagee the right to enter upon and take possession of the premises for the purposes of collecting the same and to let the premises or any part thereof, and to apply the rents, issues and profits, after payment of all necessary charges and expenses, on account of said indebtedness. This assignment and grant shall continue in effect until this mortgage is paid. The mortgagee hereby waives the right to enter upon and take possession of said premises for the purpose of

collecting said rents, issues, and profits, and Frank Lyon Company shall be entitled to collect and receive said rents, issues and profits until default under any of the covenants, conditions or agreements contained in this mortgage, and agrees to use such rents, issues and profits in payments of principal and interest becoming due on this mortgage and in payment of taxes, assessments, sewer rents, water rates and carrying charges become due against said premises, but such right of Frank Lyon Company may be revoked by the mortgagee upon any default, on five days' written notice. Frank Lyon Company will not, without the written consent of the mortgagee, receive or collect rent from any tenants of said premises or any part thereof for a period of more than one month in advance, and in the event of any default under this mortgage will pay monthly in advance to the mortgagee, or to any receiver appointed to collect said rents, issues and profits, the fair and reasonable rental value for the use and occupation of said premises or of such part thereof as may be in the possession of Frank Lyon Company, and upon default in any such payment will vacate and surrender the possession of said premises to the mortgagee or to such receiver, and in default thereof may be evicted by summary proceedings.

14. That the whole of said principal sum and the interest shall become due at the option of the mortgagee: (a) after failure to exhibit to the mortgagee, within ten days after demand, receipts showing payment of all taxes, water rates, sewer rents and assessments; or (b) after the actual or threatened alteration, demolition or removal of any building on the premises without the written consent of the mortgagee; or (c) after the assignment of the rents of the premises or any part thereof without the written consent of the mortgagee; or (d) if the buildings on said premises are not maintained in reasonably good repair; or (e) after failure to comply with any requirement or order or notice of violation of law or ordinance issued by any governmental department claiming jurisdiction over

the premises within three months from the issuance thereof; or (f) if mortgagor does not furnish adequate fire insurance coverage, and if on application of the mortgagee two or more fire insurance companies lawfully doing business in the State of Arkansas refuse to issue policies insuring the buildings on the premises; or (g) in the event of the removal, demolition or destruction in whole or in part of any of the fixtures, chattels or articles of personal property covered hereby, unless the same are promptly replaced by similar fixtures, chattels and articles of personal property at least equal in quality and condition to those replaced, free from chattel mortgages or other encumbrances thereon and free from any reservation of title thereto; or (h) if the mortgagor fails to keep, observe and perform any of the other covenants, conditions or agreements contained in this mortgage or of those contained in the building loan contract hereinafter mentioned.

15. This mortgage is made pursuant to a certain building loan agreement between the Frank Lyon Company and the mortgagee dated May 1968, and intended to be filed in the office of the Clerk of the County of Pulaski on or before the date of the recording of this mortgage, and is subject to all the provisions of said contract as if they were fully set forth herein and made part of this mortgage.

16. That without the consent of the mortgagee, Frank Lyon Company will not, and shall not have the right or power to, cancel, abridge, terminate or otherwise modify tenancies, subtenancies, leases or subleases of the premises, and that Frank Lyon Company will not accept prepayments of installments of rent to become due thereunder.

17. That the execution of this mortgage has been authorized by the board of directors of Frank Lyon Company and Worthen.

18. That within thirty (30) days after notice and demand, the Frank Lyon Company will deliver to the mort-

gagee a certified current financial statement in form satisfactory to mortgagee.

19. That there shall be no merger of the lease described herein, or of the leasehold estate created thereby, with the fee estate described therein by reason of the fact that said lease or the leasehold estate created thereby may be held by or for the account of any person or persons who shall be the owner or owners of said fee estate, unless and until all persons including mortgagee at the time having an interest in said fee estate or in said lease shall join in a written instrument declaring a contrary intent and shall duly record the same.

20. Pursuant to Section 33.2 of the lease of the Mortgaged Property between Frank Lyon Company as Lessor and Worthen as Lessee Worthen joins herein for the sole purpose of subjecting and binding all of its title, right, interest and estate in and to the Mortgaged Property to the full and faithful performance and observance of all of the terms, covenants and conditions of this mortgage. Nothing contained herein or in the note hereby secured shall be construed as obligating Worthen to pay any sums required to be paid hereunder or thereunder. Mortgagee, by accepting this mortgage, specifically concurs in the statements contained in this paragraph.

This mortgage may not be changed or terminated orally. The covenants contained in this mortgage shall run with the land and bind the mortgagor, the heirs, personal representatives, successors and assigns of the mortgagor and all subsequent owners, encumbrancers, tenants and subtenants of the premises, and shall enure to the benefit of the mortgagee, the personal representatives, successors and assigns of the mortgagee and all subsequent holders of this mortgage. The word "mortgagor" shall be construed as if it read "mortgagors" and the word "mortgagee" shall be construed as if it read "mortgagees' whenever the sense of this mortgage so requires.

IN WITNESS WHEREOF, this mortgage has been duly executed by the mortgagor.

ATTEST:

/s/ M. R. GODWIN

FRANK LYON COMPANY

By /s/ C. W. ABRAMS
President

WORTHEN BANK & TRUST

/s/ BOOKER WORTHEN

By /s/ EDWARD M. PENICK
President

(Acknowledgments Omitted in Printing)

SCHEDULE I

The land (Tract A) referred to in the Mortgaging Clause applicable to Frank Lyon Company of the Mortgage dated as of May 14, 1968, between Worthen Bank & Trust Company and Frank Lyon Company as Mortgagors and First National City Bank as Mortgagee, to which this Schedule I is attached, consists of a parcel in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

> BEGINNING at the Southwest corner of Lot 6, Block 84, Original City of Little Rock; thence northerly 160.33 feet along the West side of Lots 6, 5, 4 and 3 to a point 139.67 feet South of the Northwest corner of said Block 84; thence easterly 140.0 feet to a point on the East side of Lot 3, located 139.67 feet South of the Northeast corner of Lot 1; thence 43.88 feet in a southerly direction along the East side of Lots 3 and 4; thence easterly 160.0 feet to a point on the East side of Lot 9, located 116.45 feet North of the Southeast corner of Lot 7; thence southerly 116.45 feet along the East side of Lots 9, 8 and 7 to the Southeast corner of Lot 7; thence westerly 300.0 feet along the South side of Lots 7 and 6 to the point of beginning;

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SUBJECT, however, to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of The City of Little Rock, Arkansas, to Worthen Bank & Trust Company;

FURTHER SUBJECT to liens for unpaid taxes and assessments and to unfiled mechanics' and materialmens' liens;

LESS AND EXCEPT—

(a) the air space above the North 29.33 feet of Tract A beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

SCHEDULE II

The land (Tract B) referred to in the Mortgaging Clause applicable to Worthen Bank & Trust Company of the Mortgage dated as of May 14, 1968, between Frank Lyon Company and Worthen Bank & Trust Company as Mortgagors and First National City Bank as Mortgagee, to which this Schedule II is attached, consists of a parcel of land in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

BEGINNING at the Northwest corner of Lot 1, Block 84, Original City of Little Rock; thence easterly 140.0 feet along the North side of Lot 1 to the Northeast corner of Lot 1; thence southerly 139.67 feet along the East side of Lots 1, 2, and 3; thence westerly 140.0 feet to a point on the West side of Lot 3, located 139.67 feet South of the Northwest corner of Lot 1, thence northerly 139.67 feet along the west side of Lots 3, 2 and 1 to the point of beginning;

SUBJECT HOWEVER, To a perpetual surface easement for use by the public as a pasageway, described in an Agreement between Worthen Bank & Trust Company and Union National Bank of Little Rock, Trustee and Charles M. Taylor, Trustee, dated April 14, 1967, and recorded July 5, 1967, in Book 1001 at Pages 187-194, inclusive, of the records of the Circuit Clerk of Pulaski County, Arkansas, and further described in an Agreement dated July 26, 1967, filed for record August 2, 1967, and recorded in Book 1004 at Page 515 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by and between Worthen Bank & Trust Company and Union National Bank of Little Rock and William L. Terry, as Co-Trustees under "The Terry Trust," and Adolphine Fletcher Terry, said easement covering the north 20 feet of the South 25.17 feet of Tract B plus the turning radius described in said Agreement.

FURTHER SUBJECT to certain restrictions, conditions and reservations contained in a Special Warrant Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of City of Little Rock, Arkansas, to Worthen Bank & Trust Company.

FURTHER SUBJECT to liens for unpaid taxes and assessments and to unfiled mechanics' and materialmen's liens.

TOGETHER WITH—

(a) the air space above the North 29.33 feet of Tract A (described in Schedule I hereof) beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company, (or its assignee) against any loss or damage caused by the use of this easement.

No. 31348 Filed for Record May 14, 1968, at 3:05 P.M., and Recorded May 15, 1968. (SEAL) ROGER MCNAIR, CIRCUIT CLERK.

P. Ex. 24

No. 31349 Filed for Record May 14, 1968, at 3:06 o'clock P.M. (SEAL) and recorded May 15, 1968. ROGER MCNAIR, CLERK.

Book 1213 page 347

ASSIGNMENT

This Assignment, dated as of May 14, 1968, is made by Frank Lyon Company, an Arkansas corporation (hereafter called the "Assignor"), having its principal office at West 65th Street and Scott Hamilton Drive, Little Rock, Arkansas, to First National City Bank, a national banking association, created and existing under the laws of the United States of America, and having an office at No. 399 Park Avenue, Borough of Manhattan, City, County and State of New York (hereafter called the "Assignee").

For value received, the Assignor hereby grants, transfers and assigns to Assignee, its successors and assigns, all of the right, title and interest of the Assignor as Lessor in, to and under that certain lease dated as of May 1, 1968 (the "Building Lease"), between the Assignor as Lessor and Worthen Bank & Trust Company of Little Rock, Arkansas, as Lessee, covering among other things (i) all buildings, structures and other improvements now or hereafter located on certain real property referred to therein as Tract A and described in Schedule I thereto, together with all fixtures thereon, and (ii) the interest of the Assignor as Lessee in, to and under that certain lease dated as of May 1, 1968 (the "Ground Lease"), between Worthen Bank & Trust Company as Lessor and the Assignor as Lessee, covering Tract A described in Schedule I thereto, together with all fixtures thereon, and (ii) the interest of the Assignor as Lessee in, to and under that certain lease dated as of May 1, 1968 (the "Ground Lease"), between Worthen Bank & Trust Company as Lessor and the Assignor as Lessee, covering Tract A described in said lease.

The foregoing Assignment is for the purpose of securing (a) payment of all sums now or at any time hereafter due to the Assignee and secured by a certain mortgage dated as of May 14 1968 (hereinafter called the "Mortgage"), executed by the Assignor and Worthen Bank & Trust Company to the Assignee as mortgagee and to be recorded immediately after the recording of this Assignment, and (b) performance and discharge of each obligation, covenant and agreement of the Assignor contained herein or in the Mortgage or the secured promissory note referred to in and secured by the Mortgage.

The Assignee agrees that upon the payment in full of all indebtedness secured herby, as evidenced by the recording or filing of an instrument of satisfaction or full release of the Mortgage, this Assignment shall become and be void and of no effect.

The Assignor agrees that:

1. The Assignor will:

(a) perform or cause to be performed all of the terms, covenants and conditions on its part to be performed under the Building Lease and the Ground Lease;

(b) promptly notify the Assignee in writing of the occurrance of any default, of which the Assignor has knowledge, in the observance or performance of any of the terms, covenants and conditions to be performed under the Building Lease, or the Ground Lease, and the giving of any notice of default under such lease;

(c) whenever requested by the Assignee, at the sole cost and expense of the Assignor, take all such action as may be so requested to enforce or secure the performance of any term, covenant or condition of the Building Lease, or the Ground Lease, and to exercise any right of the Assignor under said leases;

(d) not terminate (except as permitted pursuant to Article XX of the Building Lease), modify or accept a surrender of, or offer or permit any termination (except as permitted pursuant to Article XX of the Building Lease), modification or surrender of, the Building Lease, or the Ground Lease, unless the Assignee consents in writing thereto.

2. The rights assigned hereunder include all the Assignor's right and power to modify the Building Lease or the Ground Lease or to terminate (except as permitted pursuant to Article XX of the Building Lease) or accept a surrender of said lease or to waive or release any person from the performance or observance of any obligation or condition thereof.

3. If the Assignor shall fail to perform any of its coveants in this Assignment, the Assignee may at any time and from time to time at its discretion make advances to effect performance of any such covenant on behalf of the Assignor; and all such moneys advanced by the Assignee, together with interest at the rate of ten percent (10%) per annum, shall be repaid by the Assignor upon demand and shall be secured hereby and by the Mortgage, but no such advance shall relieve the Assignor from defaults hereunder.

4. The Assignee may, to the extent permitted by law, in case one or more of the Events of Default described in the Mortgage shall happen and shall not have been remedied, enter into and upon all or any part of the premises covered under the Building Lease or the Ground Lease and may exclude the Assignor and all persons claiming under the Assignor, wholly or partly therefrom; and holding the same, the Assignee may use, operate, manage and control said premises and conduct the business thereof, and exercise all rights and powers of the Assignor, including all the rights, powers and remedies conferred upon or reserved to the Assignor by the Building Lease or the

Ground Lease, either in the name of the Assignor or otherwise, as the Assignee shall deem best. Upon every such entry and to the extent permitted by law without such entry, the Assignee may collect the rents, profits, revenues and other income payable under the Building Lease and apply the same after payment of all necessary charges and expenses to the payment of all sums secured hereby.

5. The Assignee shall not be obligated to perform or discharge any obligation under either the Building Lease or the Ground Lease, or under or by reason of this Assignment, and the Assignor hereby agrees to indemnify the Assignee against and hold it harmless from any and all liability, loss or damage which it may or might incur under either of said leases or under or by reason of this Assignment and of and from any and all claims and demands whatsoever may be asserted against it by reason of any alleged obligation or undertaking on its part to perform or discharge any of the terms of said leases. If the Assignee should incur any such liability, loss or damage under either of said leases or under or by reason of this Assignment, or in defense against any such claims or demands, the amount thereof including costs, expenses and reasonable attorneys' fees, together with interest thereon at ten percent (10%) per annum, shall be secured hereby, and the Assignor shall reimburse the Assignee therefor immediately upon demand.

6. This Assignment shall inure to the benefit of the successors and assigns of the Assignee and bind and inure to the benefit of the successors and assigns of the Assignor.

IN WITNESS WHEREOF, the Assignor has caused this Assignment to be duly executed, all as of the day and year first above written.

FRANK LYON COMPANY

By .....
President

Attest:

M. R. GODWIN
Secretary

(Acknowledgment Omitted in Printing)

No. 31349 Filed for Record May 14, 1968, at 3:06 P.M., and Recorded May 15, 1968. (SEAL) ROGER MCNAIR, CIRCUIT CLERK.

P. Ex. 25

SALES AGREEMENT

THIS SALES AGREEMENT executed on this 19th day of May, 1968 by and between the FRANK LYON COMPANY, a corporation organized under the laws of the State of Arkansas (hereinafter referred to as "the Company") and WORTHEN BANK & TRUST COMPANY, a banking association organized under the laws of the State of Arkansas (hereinafter referred to as "the Bank");

W-I-T-N-E-S-S-E-T-H

WHEREAS, the Bank has purchased certain real property located in Little Rock, Arkansas (hereinafter referred to as as "Track A") and has let and demised Tract A to the Company under a lease agreement (hereinafter referred to as the "Ground Lease"); and

WHEREAS, the Bank has entered into a contract (hereinafter referred to as the "Construction Contract") for the construction of a twenty-four (24) story building (hereinafter referred to as the "Bank Building") on Tract A, and a parking garage on an adjacent tract; and

WHEREAS, legal restrictions with respect to the ownership of real estate by a bank will not permit the Bank to own both the Bank Building and the aforesaid parking garage; and

WHEREAS, the Company and its affiliates own improved real estate in Arkansas and elsewhere and the Company is desirous of making a further investment in real estate through the purchase of the Bank Building; and

WHEREAS, the Company has entered into an agreement (hereinafter referred to as the "Building Loan Agreement") with First National City Bank, New York, New York, for the financing of the construction of the Bank Building; and

WHEREAS, the Company has entered into an agreement (hereinafter referred to as the "Note Purchase Agreement") with New York Life Insurance Company for the permanent financing of the purchase of the Bank Building; and

WHEREAS, the Company has let and demised the Bank Building and its interest in the Ground Lease to the Bank under a lease agreement (hereinafter referred to as the "Building Lease"); and

WHEREAS, said Ground Lease, Construction Contract, Building Loan Agreement, Note Purchase Agreement, Building Lease, and all of the exhibits to each of the aforesaid agreements are attached hereto as EXHIBITS "A", "B", "C", "D", and "E", respectively, are hereinafter collectively referred to as "Exhibits", and are incorporated herein as though set forth in full.

NOW, THEREFORE, subject to the following terms and conditions the parties hereto agree as follows:

1. *Representations and Warranties.* The Bank represents and warrants as follows:

(a) The Bank is a banking corporation duly incorporated and validly existing under the laws of the State of Arkansas and is in good standing in said State.

(b) There are no material actions, suits or proceedings pending or to the knowledge of the Bank threatened against or affecting the Bank or its property, at law or in equity or before or by any Federal, State, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, except actions, suits or proceedings of the character normally incident to the kind of business conducted by the Bank which, if adversely determined, would not materially impair the Bank's right to carry on its business substantially as now con-

ducted or proposed to be conducted; and the Bank is not in default with respect to any material order, writ, injunction, decree or demand of any court or Federal, State, municipal or other governmental department, commission, board, bureau, agency or instrumentality.

(c) The consummation of the transactions contemplated by this Sales Agreement and Exhibits will not result in the breach of, or constitute a default under, any indenture, mortgage, deed of trust, bank loan or credit agreement, corporate charter, by-law or other agreement or instrument to which the Bank is a party or by which the Bank or its properties may be bound or affected.

(d) The Bank is duly authorized to enter into this Sales Agreement and any of the Exhibits to which it is a party.

(e) The Bank has good clear record and marketable title in fee simple absolute to Tract A, free and clear of all liens, charges, and encumbrances, except: (1) the interest of the Company as Lessee under the Ground Lease; (2) the interest of First National City Bank, New York, New York, under the Building Loan Mortgage which is an Exhibit to the Building Loan Agreement; and (3) inchoate unfiled mechanics or materialmen's liens.

(f) The Construction Contract is a valid, legal, enforceable and existing contract with Matson-Bellows for the construction of a twenty-four (24) story and single basement bank and office building, with six (6) elevators and about 217,860 square feet of net rentable space, and the Bank is not in default with respect to it.

(g) The construction of the Bank Building will be fully completed by the Closing Date (as defined in paragraph 7 hereof) in accordance with the Construction Contract, free from all liens and claims which may

be filed or made for performing work and labor thereon or furnishing materials therefor, or both, and that the total cost of such construction will be at least $7,640,000.00.

(h) That is has received the valid approval of the Board of Governors of the Federal Reserve System and of the Bank Commissioner of the State of Arkansas for the consummation of the transactions contemplated by this Sales Agreement, and Exhibits to the extent that such approval is required.

(i) All representations and warranties by the Bank herein and any certificates delivered pursuant hereto shall survive the execution of this Sales Agreement, and the consummation of all the transactions provided for in this Sales Agreement and shall be deemed to be relied upon by the Company notwithstanding any inquiry or investigation which the Company may make in respect to the truth or accuracy of such representations and warranties.

2. *Sale of the Bank Building.* Subject to the terms of this Sales Agreement, the Company hereby agrees to purchase from the Bank, and the Bank agrees to sell to the Company the Bank Building (as that term is defined in paragraph 2(a) hereof) but not Tract A, for the consideration (the "purchase price") provided in paragraph 2(b) hereof. Title to the materials shall pass to the Company as the materials are incorporated into the Bank Building.

(a) For the purpose hereof "the Bank Building" shall mean the twenty-four (24) story building located on Tract A, including all machinery and fixtures of every kind and nature whatsoever which may be used or procurred in connection with the operation and maintenance of the Building which shall include, but not be limited to, engines, motors, generators, dynamos, pumps, furnaces, boilers, incinerators, oil burn-

ers, radiators and piping, stokers, heaters, tanks and heating equipment, wiring and electrical equipment, gas, electric, lighting, heating, plumbing and bathroom fixtures, including pipes and conduits, elevators, escalators and lifting apparatus, refrigerating, air cooling, air conditioning, ventilating and sprinkling apparatus, partitions, built-in kitchen and restaurant equipment, plants and shrubbery and well-to-wall carpeting and all other equipment and furnishings used or procurred for use in connection with the operation and maintenance of the Building, together with all replacements thereof and additions thereto but specifically excluding safety deposit boxes, vault doors, banking trade fixtures, furniture, china, glassware, silverware and such other personalty as may, from time to time, be listed on the Schedule of Bank Personalty which is attached hereto.

(b) In consideration for the sale of the Bank Build- to the Company, the Company shall pay to the Bank as the purchase price an amount to be determined and paid as hereinafter provided: (1) The Company shall pay in a series of periodic installments which will be be made not more frequently than once a month, based upon the certification of COTHAM, WYLAND & HOWLAND, Certified Public Accountants, certifying as to the cost of work in place at each stage of construction and the certification of ERHARD, EICHENBAUM, RAUCH & BLASS, Architects, certifying as to the aggregate percentage of work in place in each stage in an amount sufficient to imburse the Bank for its expenditures, in constructing the Bank Building. The Company may require seven (7) days notice in writing from the Bank before an advance shall be called for. All advances are to be made at the office of the Company or at such other place or in such manner as the Company shall designate. At the time of the request for an advance the Bank shall furnish to the Company the following:

a a certificate of the architect or engineer in charge of construction dated not more than thirty (30) days prior to such request setting forth that the sum then requested either has been paid by the Bank and/or is justly due to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered services or furnished materials for the construction of the Bank Building and giving a brief description of such services and materials and the principal subdivisions or categories thereof and the several amounts so paid and/or due to each said persons in respect thereof, also stating the fair value of such construction at the time of acquisition thereof; and that, except for the amounts, if any, stated in the certificate to be due for services or materials, there is no indebtedness known, after due inquiry to said architects, or engineers which is then due and payable for labor, wages, services, materials or supplies in connection with said construction, which, after unpaid, might become the basis of a Vendors', Mechanics', Laborers', Materialmens', Statutory or other similar lien upon the Bank Building or any part thereof; and

b an affidavit sworn to be an Exeecutive Office of the Bank not more than thirty (30) days prior to the application for such withdrawals setting forth in substance that all materials and all properties used in the construction described in said certificate, pursuant to the foregoing subsection *a* of this section and every part thereof are free and clear of all encumbrances, except those created by the Company, and undetermined or inchoate liens or charges for indebtedness incidental to such constructions, and which have not been filed pursuant to the laws, and except encumbrances, if any, securing an indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said

certificate pursuant to the foregoing subsection *a* of this section which encumbrance shall be discharged upon payment of such indebtedness; and that no part of the several amounts paid and/or due as stated in said certificate pursuant to the foregoing subsection *a* of this section has been or is being made the basis of a request for payment in any previous or then pending application; and that there is no default by the Company under the Construction Contract.

(2) All of the reimbursements by the Company to the Bank as herein provided shall not, in the aggregate exceed $7,640,000.00, less an amount (hereinafter referred to as the "Company Cost") equal to the sum of (i) any direct expenses of the type referred to in Section 6, and (ii) interim interest on the construction loan which is paid by the Company.

(3) No advance shall be due unless, in the judgment of the Company, all work done at the stage of construction which the advance is made payable has been done in a good and workmanlike manner, and all materials and fixtures usually furnished and installed at that time have been furnished and installed, and unless all construction be approved by the architect, but the Company may advance parts or the whole of any installments before they become due, if the Company believes it advisable so to do, and all such advances or payments shall be deemed to have been made in pursuance of this Agreement and not to be modifications thereof. The making of any advance or any part of an advance shall not be deemed an approval or acceptance by the Company of the work theretofore done. Any advance or installment or any part or parts thereof may be postponed or deferred by mutual consent of the Bank and the Company, and any such postponement or postponements shall be deemed to be in pursuance of this Agreement and not in modification thereof.

3. *Covenants.* The Bank hereby covenants and agrees as follows:

(a) The Bank expressly covenants to cause to be erected on Tract A the Worthen Building in accordance with the Construction Contract dated November 8, 1967 between Matson-Bellows and Worthen and with the plans and specifications therefor which the Bank agrees to file or cause to be filed with all governmental authorities having jurisdiction and to obtain or cause to be obtained all necessary approvals of said plans and specifications and all necessary buildings permits from said authorities. The said plans and specifications shall first be submitted to and approved by the Company, and no changes or amendments thereto shall be made without first obtaining the approval of the Company.

(b) The Bank shall furnish or cause to be furnished to the Company, on or before the making of the final advance, the final certificates of approval, including certificate of occupancy, of the various governmental authorities having jurisdiction and the certificate of the Board of Fire Underwriters acting in and for the locality in which the said premises are situated.

(c) The Bank shall furnish or cause to be furnished to the Company, or the Company may procure at the expense of the Bank, surveys made by a surveyor satisfactory to the Company whenever required by the Company.

(d) The Bank shall furnish or cause to be furnished to the Company premiums prepaid, or the Company may procure at the expense of the Bank, the standard builders risk insurance policies in companies, forms and amounts satisfactory to the Company insuring the premises against loss or damage by fire, with the usual extended coverage endorsement, and other hazards as

may reasonably be required by the Company, and insuring the Company as owner.

(e) The Company may at the expense of the Bank employ a watchman to protect the building and its contents from depredation or injury.

(f) If the construction of said building be at any time discontinued or not carried on with reasonable dispatch in the judgment of the Company, said Company may purchase materials and employ workmen to protect said building so that the same will not suffer from depredation or the weather, or to complete said building so that it may be used for the purposes for which it is designed under the said plans and specifications.

(g) The Bank will not assign this contract or the moneys due thereunder or convey or encumber the property without the written consent of the Company, but in such event the Company may nevertheless at the option of the Company, continue to make advances under this Agreement to the Bank or to those who succeed to the Bank's title; and all sums so advanced by the Company shall be deemed advances under this Agreement, and not to be modifications thereof.

(h) The Bank will furnish a complete set of "as built" plans and specifications for the Building not less than five (5) days prior to the Closing Date.

(i) The Bank will fully perform all of its obligations under any of the Exhibits to which it is a party, and will not do or permit anything within its control to be done which will impair or destroy the rights of the Company under any of the Exhibits.

(j) The Bank agrees to indemnify and save the Company harmless against and from any and all claims by or on behalf of any person or persons, firm

or firms, corporation or corporations arising out of the failure to deliver the completed Bank Building to the Company on or before the Closing Date, whether or not the Bank is at fault in connection with such failure unless the failure is the result of the act or omission of the Company.

4. *Representations and Warranties by the Company.* The Company represents and warrants that:

(a) *Organization and Standing of the Company.* The Company is a corporation duly organized and validly existing and in good standing under the laws of the State of Arkansas and has all requisite corporate power and authority to carry on its business as conducted and as proposed to be conducted, to enter into this Agreement, and to carry out the transactions contemplated thereby.

(b) *Qualification.* The Company is duly qualified and in good standing and authorized to do business in the State of Arkansas.

(c) *Solvency and Liabilities.* The Company is a solvent corporation and on December 31, 1967, had a net worth in excess of $3,000,000.00.

(d) *Litigation.* There is no action, proceeding or vestigation pending or (to the knowledge of the Company) threatened, or any basis therefor known to the Company, which might materially adversely affect the condition, business or prospects of the Company or any of its properties or assets, or which questions the validity of this Agreement or any instrument referred to herein or any action taken or to be taken pursuant hereto or thereto.

(e) *Compliance with Other Instruments.* The execution, delivery and performance of this Agreement and the carrying out of the transactions contemplated

hereby will not result in any violation of or be in conflict with any terms of the Company's articles of incorporation or by-laws or of any agreement, court orders, statute or governmental rule or regulation applicable to the Company, or result in the creation of any mortgage, lien or encumbrance (other than described herein) upon any of the properties or assets of the Company pursuant to any such term. There is no such term which materially adversely affects or in the future may, so far as the Company can now foresee, materially adversely affect the business, prospects or condition of the Company or any of its properties or assets.

(f) *Governmental Consent.* No approval, consent, order or authorization of or designation, registration, declaration or filing with any governmental or public body or authority on the part of the Company is required in connection with the valid execution and with any of the transactions contemplated hereby, except for the appropriate recordation of any of the instruments referred to herein.

(g) *Disclosure.* No certificate, statement or other document furnished the Bank by the Company or on its behalf in connection with transactions contemplated herein, nor this Agreement, contains any untrue statement of a material fact.

5. *Default by the Bank.* In the event of the occurrance of any of the following defaults by the Bank prior to the Closing Date, the Company at its option may require the Bank to repurchase the Bank Building for an amount equivalent to the sum of all reimbursements paid to the Bank under paragraph 2(b) hereof plus all expenses incurred by the Company under paragraph 6 hereof, plus interest thereon at the rate of ten per cent (10%) per annum from the date of such reimbursement or the payment of such expenses, such payments may be made through the satisfaction of the Building Loan Mortgage Note of First National City Bank, with the remainder paid in cash:

(a) The failure of the Bank to fulfill any of its obligations under this Sales Agreement or the Exhibits, unless such failure is the result of a prior default by the Company.

(b) If any representation or warranty of the Bank in this Sales Agreement, or the Exhibits, or any certification or affidavit furnished thereunder shall be or become false or misleading in any material respect.

6. *Expenses.* If the transactions contemplated hereby shall be consummated, the Company shall pay or cause to be paid:

(a) The cost, if any, of printing or reproducing this Agreement and the instruments attached as Exhibits hereto.

(b) The cost of filing or recording of any of the instruments attached as Exhibits hereto, including the cost of any additional or later filing or recording of any such instruments required by the applicable local law at the time in effect, and of any opinions of counsel obtained in connection therewith.

(c) The fees, expenses and disbursements of Company counsel, counsel for First National City Bank and counsel for New York Life Insurance Company.

(d) The cost of any title insurance and survey required hereby.

(e) Any brokerage fees.

(f) Any commitment fees.

(g) All reasonable out-of-pocket expenses incurred by the Company in connection with the transactions contemplated hereby.

7. *Closing Date.* The Closing Date shall be on the first mutually convenient date following completion of the construction of the Bank Building on or before December 1, 1969, or the date on which New York Life Insurance Company purchases the Note of the Company pursuant to paragraph 3 of the Note Purchase Agreement, whichever occurs later. On or before the Closing Date the Bank shall deliver to the Company a Warranty Deed in the form satisfactory to counsel for the Company, conveying title to the Bank Building.

8. *Subordination.* The rights and privileges of the Company and the Bank pursuant to this instrument, and all of the terms, conditions, covenants, agreements and provisions herein contained shall be subject and subordinate to the rights of New York Life Insurance Company under the Note Purchase Agreement or under the note described therein ("The Note") which it is contemplated will be purchased by New York Life Insurance Company pursuant thereto or under the Deed of Trust or any other instrument mentioned therein as being security for payment of the Note. This subordination shall be self-operative and no further instruments of subordination shall be required. Nevertheless, the Company and the Bank covenant and agree that they will, at any time and from time to time, execute, acknowledge and deliver, such instruments and certificates (in form, scope and substance satisfactory to New York Life Insurance Company) affirming and confirming such subordination as New York Life Insurance Company may reasonably request.

9. *Insolvency.* In the event of a Company default under Section 16.1 (h) or (i) of the Deed of Trust with New York Life Insurance Company then the Bank shall have the

right to purchase the Bank Building for an amount equal to the mean between two amounts determined to have been the fair market value of the Bank Building as of the date immediately prior to such default by the Company. Such amounts shall be determined by two independent appraisers who are members of M. I. A. One appraiser shall be selected by the Bank and one by the Company; but if the Company shall fail to select an appraiser within three days after receipt of written notice of the Bank's election hereunder, then the Bank shall have the right to designate the second appraiser. Such right may be exercised by giving three days' written notice to the Company and tendering the aforesaid amount in cash to the Company. Any reference to the Company hereunder shall include any Court or Court appointed referee, receiver or trustee who is in charge of the affairs of the Company.

10. For so long as the Bank is not in default with respect to its obligations under any of the Exhibits, the Bank shall have the sole and exclusive right to determine the name of the Bank Building, and the Company will make an irrevocable general election conforming to the requirements of Section 48 of the Internal Revenue Code of 1954, as the same may from time to time be amended, to treat the Bank as having purchased any property which is purchased hereunder during such taxable year, and to do or perform any other acts desirable or necessary to assign to the Bank the credit against Federal income tax presently afforded by Section 38 of the Internal Revenue Code of 1954, as the same may from time to time be amended.

11. *General.* This Agreement is being delivered and is to be performed in the State of Arkansas, and shall be construed and enforced in accordance with and governed by the laws of the State of Arkansas. This Agreement embodies the entire understanding between the Company and the Bank and supersedes all prior agreements and understandings relating to the subject matter hereof. Neither this Agreement nor any term hereof may be changed, waived, discharged or terminated orally, but only

by an instrument in writing signed by the party against which enforcement of the change, waiver, discharge or termination is sought. All of the terms of this Agreement shall be binding upon and inure to the benefit of and be enforceable by the respect successors and assigns of the party hereto. The headings in this Agreement are for convenience of reference only and shall not limit or otherwise affect any of the terms hereof. Any instrument required by any provision hereof to be in the form attached hereto as an Exhibit shall be substantially in such form, which such changes, if any, as may be required by any other party thereto and approved by the Bank and by the Company. This Agreement may be executed in any number of counterparts, each of which shall be an original, but all of which together shall constitute one and the same instrument.

In Witness Whereof, the parties hereto have duly executed this Agreement the day and year first above written.

Frank Lyon Company
By: /s/ C. W. Abrams
President

Attest:
/s/ M. R. Godwin
Secretary

Worthen Bank & Trust Company

By: /s/ Edward M. Penick
President

Attest:
/s/ Booker Worthen
Secretary

(Acknowledgment Omitted in Printing)

Schedule of Bank Personalty

The following list of personal property is or has been incorporated into the Bank Building and is the exclusive property of the Bank. This schedule is not valid unless executed by the Frank Lyon Company and Worthen Bank & Trust Company, acknowledging the Bank ownership of any property listed.

P. Ex. 26

FRANK LYON COMPANY

6¾% SECURED NOTE

$7,140,000.00

Little Rock, Arkansas
December 1, 1969

Frank Lyon Company, an Arkansas corporation (hereinafter called "the Company"), for value received hereby promises to pay to the order of New York Life Insurance Company (hereinafter called "the Payee"), at its principal office in the Borough of Manhattan, City, County and State of New York, or such other place as the holder shall from time to time designate, the principal sum of Seven Million One Hundred Forty Thousand and No/100 Dollars in such coin or currency of the United States of America as at the time of payment shall be legal tender for the payment of public and private debts, and to pay interest on the unpaid balance of said principal sum from the date hereof, in like coin or currency, at said principal office, or said other place, at the rate of six and three-fourths per cent (6¾%) per annum (computed on the basis of a 360-day year of twelve 30-day months) until maturity, and thereafter at the rate of eight per cent (8%) per annum, payment of such principal and interest to be made as hereinafter set forth in quarter-annual installments, payable on February 28, May 31, August 31, and November 30, of each year, commencing February 28, 1970, to and including November 30, 1994.

In order to provide for the payment of the principal of and interest on this note, the Company will pay to the holder forty-four (44) installments of One Hundred Forty-Five Thousand Five Hundred Eighty-One and 03/100 Dollars ($145,581.03) each, in said coin or currency, quarter-annually on February 28, May 28, May 31, August 31, and November 30, of each year, commencing February 28, 1970 to and including November 30, 1980, and fifty-six (56) in-

stallments of One Hundred Fifty-Three Thousand Two Hundred Eighty-Nine and 32/100 Dollars ($153, 289.32) each, in said coin or currency, quarter-annually on February 28, May 31, August 31, and November 30, of each year, commencing February 28, 1981, to and including November 30, 1994. All payments made pursuant to this paragraph shall be applied by the Payee first to the payment of interest on this note and the balance to the payment of principal of this note.

Upon not less than thirty (30) days' written notice to the Payee, given as provided in the below-mentioned Note Purchase Agreement, the Company may at its option prepay this Note in full, plus accrued interest thereon to the date fixed for such prepayment, plus a premium as set forth in paragraph (c) below, on the following terms and conditions:

(a) Except as provided in paragraph (b) below, there may be no prepayment prior to December 1, 1980.

(b) In the event that the Building Lease between the Company and Worthen Bank & Trust Company, dated May 1, 1968, is terminated pursuant to Section 18.1 thereof, prepayment may be made either before or after December 1, 1980.

(c) To prepay this note, the Company shall a premium equal to the applicable percentage of the then unpaid principal amount, determined as follows:

Date of Prepayment	Percentage Applicable
Prior to December 1, 1980, applicable only if paragraph (b) above applies	3.50
During the 12-month period beginning December 1	
1980	3.50
1981	3.25
1982	3.00
1983	2.75
1984	2.50
1985	2.25
1986	2.00
1987	1.75
1988	1.50
1989	1.25
1990 and thereafter	1.00

This note is the note issued and sold pursuant to a certain Note Purchase Agreement dated as of May 1, 1968, entered into by the Company with the Payee. This note is secured by, and is entitled to the benefits of, a certain Deed of Trust dated as of December 1, 1969, and a certain Assignment dated as of December 1, 1969, each executed and delivered by the Company to the Payee.

The maturity of this note may be accelerated and the whole of the principal sum and interest thereon shall become due and payable at the option of the holder hereof, without notice, upon the happening of an Event of Default as defined in the Deed of Trust referred to above.

The makers, endorsers, sureties and guarantors hereof hereby severally waive presentment for payment, notice of non-payment, protest and notice of protest, and diligence in enforcing payment hereof, and consent that the time of payment may be extended without notice from time to time.

If the holder of this note employs an attorney to enforce any of the provisions hereof, the maker shall be liable to the holder for reasonable attorney's fees of the holder not to exceed ten per centum (10%) of the principal and accrued interest then due. This provisions is intended to be in compliance with the provisions of Act 350 of the 1951 General Assembly of the State of Arkansas.

FRANK LYON COMPANY

By .....
President

Attest:

.....
Secretary

P. Ex. 27

WORTHEN BANK & TRUST COMPANY

AND

FRANK LYON COMPANY,
As Grantors

TO

DARRELL D. DOVER,
As Trustee

AND

NEW YORK LIFE INSURANCE COMPANY
As Beneficiary

FIRST DEED OF TRUST

Dated as of December 1, 1969

Securing

6¾% Secured Note

(Table of Contents Omitted in Printing)

DEED OF TRUST

DEED OF TRUST, dated as of December 1, 1969, between the following (collectively, the "Grantors"):

(a) Frank Lyon Company (the "Company"), an Arkansas corporation having its principal office and place of business at West 65th Street and Scott Hamilton Drive, Little Rock, Arkansas, and

(b) Worthen Bank & Trust Company (the "Bank"), a banking corporation under the laws of Arkansas, with its principal office and place of business

at Center Street and Capitol Avenue, Little Rock, Arkansas,

and Darrell D. Dover (the "'Trustee"), having his residence at Tower Building, Little Rock, Arkansas, and acting for the benefit of New York Life Insurance Company (the "Beneficiary"), a New York corporation:

To Secure the Payment when and as due and payable of the principal of and the premium, if any. and interest on the Company's 6¼% Secured Note (the "Note") of even date herewith in the principal amount of $7,140,000 payable quarter-annually on which payments are to be made from time to time in accordance with the terms thereof; and also to secure performance by the Company and the Bank of all agreements and conditions contained herein and of all agreements of the Company contained in the Assignment and in the Note Purchase Agreement dated as of May 1, 1968, between the Company and the Beneficiary, and of all agreements of the Bank contained in the Consent and Agreement dated as of December 1, 1969;

The Company Does Hereby Grant, bargain, sell, assign, pledge and convey to the Trustee and to his successors and assigns forever the following properties (collectively, "Company Property"):

(a) all buildings, structures and other improvements now are hereafter located on certain real property hereinafter referred to as "Tract A" and described in Schedule I hereto, together with all fixtures now or hereafter attached to or located thereon (collectively, "Company Improvements"), subject (except as provided in Section 17.4 hereof) to the Building Lease described below, and

(b) all right, title and interest of the Company as Lessor in, to and under that certain lease dated as of May 1, 1968 (the "Building Lease"), between the

Company as Lessor and the Bank as Lessee covering, among other things, the Company Improvements together with rentals payable thereunder, and

(c) all right, title and interest of the Company as Lessee in, to and under that certain lease dated as of May 1, 1968 (the "Ground Lease"), between the Bank as Lessor and the Company as Lessee, covering Tract A;

all subject, however, to Permitted Encumbrances (as defined in Section 1.1).

And the Bank Does Hereby Grant, bargain, sell, assign, pledge and convey to the Trustee and to his successors and assigns forever the following properties (collectively, "Bank Property"):

(a) Tract A, subject to the Ground Lease, and

(b) certain real property hereinafter referred to as "Tract B" and described in Schedule II hereto, together with all buildings, structures, fixtures and other improvements now or hereafter attached to or located thereon (collectively, the "Parking Facility");

all subject, however, to Permitted Encumbrances (as defined in Section 1.1).

Provided, However, That the Bank joins as one of the Grantors in the execution of this Deed of Trust with respect to Bank Property solely (a) to further induce the Beneficiary to purchase the Note and (b) to comply with Section 33.1 of the Building Lease which requires the Bank to execute this Deed of Trust as a further inducement to the Beneficiary to purchase the Note; and that such execution hereof shall never be deemed to create any liability on the part of the Bank, contingent or otherwise, with respect to payment of the Note, or with respect to performance of any obligation of the Company hereunder;

and the Beneficiary specifically concurs in the above by accepting this Deed of Trust; and

Further Provided That the Company Property and the Bank Property shall include all awards with respect to any Taking (as defined in Section 1.1) thereof;

To Have and to Hold the Company Property and the Bank Property (hereafter sometimes collectively referred to as "the Property") unto the Trustee, his successors and assigns forever.

In Trust, Nevertheless, upon the terms and trusts herein set forth.

And the Company hereby binds itself, its successors and assigns, to warrant and forever defend the Company Property to the Trustee and his successors and assigns, against the claims and demands of all persons whomsoever.

And the Bank hereby binds itself, its successor and assigns, to warrant and forever defend the Bank Property to the Trustee and his successors and assigns, against the claims and demands of all persons whomsoever.

It Is Hereby Covenanted by the parties hereto that the Company Property and the Bank Property is to be held and applied subject to the further terms herein set forth; and the Company and the Bank for themselves and their successors and assigns hereby covenant and agree with the Trustee for the benefit of the Beneficiary as follows:

ARTICLE I

DEFINITIONS

Section 1.1. *Terms Defined.* As used in this Deed of Trust, the following terms have the following respective meanings:

(1) *Additional Rent:* as defined in the Building Lease.

(2) *Assignment:* the Assignment dated as of December 1, 1969, wherein the Company has assigned to the Beneficiary the Company's interest as Lessor in and to the Building Lease.

(3) *Basic Rent:* as defined in the Building Lease.

(4) *Beneficiary:* New York Life Insurance Company or (if appropriate) the then holder of the indebtedness secured hereby.

(5) *Company Order and Company Request:* respectively, and order or request signed in the name of the Company or the Bank by the President or a Vice President and by the Treasurer or an Assasistant Treasurer of the Secretary or an Assistant Secretary, and delivered to the Beneficiary.

(6) *Default:* any condition or event which constitutes or which, after notice or lapse of time or both, would constitute an Event of Default.

(7) *Events of Default:* as defined in Section 17.1.

(8) *Officers' Certificate:* a certificate signed by the President or a Vice President and by the Treasurer or an Assistant Treasurer of the Company or the Bank and delivered to the Beneficiary.

(9) *Opinion of Counsel:* a written opinion of counsel, who may be counsel for the Company or the Bank, selected by the Company or the Bank and acceptable to the Beneficiary.

(10) *Permitted Encumbrances:* (a) liens for taxes and assessments not due and delinquent or being contested as provided herein, and (b) unfiled mechanics' and materialmen's liens.

(11) *Restoration:* as definied in Section 12.2.

(12) *Taking:* a taking of all or any part of the Property, or any interest therein or right accruing thereto, including,

without limitation, any right of access thereto existing on the date of this Deed of Trust, as the result of or in lieu or in anticipation of the exercise of the right of condemnation or eminent domain, or a change of grade affecting the Property or any part thereof.

(13) *Total Destruction:* as defined in Section 12.3.

(14) *Total Taking:* as defined in Section 13.3.

(15) *Trust Estate:* the Property at the time subject to this Deed of Trust and all other properties and moneys at the time subject to the lien of this Deed of Trust or held by the Trustee hereunder.

(16) *Unavoidable Delays:* delays due to strikes, acts of God, governmental restrictions, enemy action, civil commotion, fire, unavoidable casualty or other causes beyond the control of the Company and/or the Bank. Lack of funds shall not be deemed a cause beyond the control of the Company and/or the Bank.

SECTION 1.2. *References to "Grantors" and "Property."* Although the term "Grantors" shall means the Company and the Bank collectively, nevertheless the duties imposed herein upon the Grantors with respect to the Property shall be imposed only upon the Company with respect to Company Property and only upon the Bank with respect to Bank Property, anything herein contained to the contrary notwithstanding.

ARTICLE II

THE NOTE

SECTION 2.1. *Payment of Note.* The Company will duly and punctually pay

(a) the principal of and the premium, if any, and interest on the Note in accordance with its terms, and

(b) when and as due and payable, all other indebtedness secured hereby for which it is liable.

SECTION 2.2. *Optional Prepayment.* The Company may, at its option, prepay the Note in accordance with and to the extent permitted by the terms thereof.

ARTICLE III

TITLE AND AUTHORITY

SECTION 3.1. *The Company.* The Company represents and warrants that it has good and marketable title in fee simple absolute to the Company Property, subject to no lien, encumbrance or charge other than the Building Lease and Permitted Encumbrances, and that it has good and lawful right and authority to execute this Deed of Trust. The Company at its expense will warrant and defend to the Trustee such title to the Company Property and the lien and interest of the Trustee against all claims and demands and will maintain and preserve such lien so long as the Note is outstanding.

SECTION 3.2. *The Bank.* The Bank represents and warrants that it has good and marketable title in fee simple absolute to the Bank Property, subject to no lien, encumbrance or charge other than the Ground Lease and Permitted Encumbrances, and that it has good and lawful right and authority to execute this Deed of Trust. The Bank at its expense will warrant and defend to the Trustee such title to the Bank Property and the lien and interest of the Trustee against all claims and demands and will maintain and preserve such lien so long as the Note is outstanding.

ARTICLE IV

WARRANTIES AS TO LEASES

SECTION 4.1. *Warranty as to Building Lease.* The Grantors warrant that the Building Lease is a valid and subsisting lease of the Company Improvements purported to be leased thereby for the term therein set forth, that

the copy thereof filed with the Beneficiary is a true, correct and complete copy thereof, and that there is no default under the Building Lease.

SECTION 4.2. *Warranty as to Ground Lease.* The Grantors further warrant that the Ground Lease is a valid and subsisting lease of Tract A purported to be leased thereby for the term therein set forth, that the copy thereof filed with the Beneficiary is a true, correct and complete copy thereof, and that there is no default under the Ground Lease.

ARTICLE V

RECORDATION

SECTION 5.1. The Grantors at their expense will at all times cause this Deed of Trust and any amending or supplemental instrument or financing statement with respect thereto to be recorded and filed and to be kept recorded and filed in such manner and in such places, and will pay all such recording and filing fees and other charges, and will comply with all such statutes and regulations, as may be required by law in order to establish, preserve and protect the lien of this Deed of Trust as a valid first Deed of Trust lien of record on the Property.

ARTICLE VI

MAINTENANCE AND REPAIRS

SECTION 6.1. The Grantors at their expense will keep the Property and the adjoining sidewalks, curbs, and vaults in good and clean order and condition and will make all necessary and appropriate repairs, replacements and renewals thereof, whether interior or exterior, structural or non-structural, ordinary or extraordinary, foreseen or unforeseen. All repairs, replacements and renewals shall be equal in quality and class to the original work. The Grantors at their expense, will do all shoring of foundation and

walls of the Company Improvements and/or Parking Facility or of the ground adjacent thereto and will do every other act necessary or appropriate for the preservation and safety of the Company Improvements and/or Parking Facility by reason of or in connection with any excavation or other building operation upon Tract A or Tract B or any adjoining property.

ARTICLE VII

PAYMENT OF TAXES AND CLAIMS FOR LABOR AND MATERIALS

SECTIONS 7.1. *Payments.* The Grantors shall promptly pay and discharge before any penalty attaches thereto all taxes, rates, impositions, assessments and governmental charges or levies imposed upon the Property or any part thereof, as well as all claims for labor, materials and supplies which, if unpaid, might become a lien or charge upon the Property, so that the lien of this Deed of Trust shall at all times be wholly preserved without expense to the Beneficiary.

SECTION 7.2. *Contests.* The Grantors shall not be required to pay any such tax, rate, imposition, assessment, charge, levy or claim (1) if the validity, applicability or amount thereof shall currently be contested in good faith by appropriate proceedings, and (2) if the Appropriate Grantor (Company with respect to Company Property and Bank with respect to Bank Property) shall have furnished the Beneficiary an Opinion of Counsel stating that the nonpayment of such item pending such contest will not subject any part of the Property to forfeiture or loss (including loss by reason of the termination or cancellation of either the Building Lease or the Ground Lease). The Appropriate Grantor shall set aside on its books adequate reserves with respect to such contested liability and shall furnish such security, if any, as may be required in the proceedings or reasonably requested by the Beneficiary.

This security may include a deposit of a sum equal to the amount so contested and unpaid together with all interest and penalties in connection therewith and all charges that may or might be assessed against or become a charge on the Property or any part thereof in said proceedings. If at any time during the continuance of such proceedings the Beneficiary shall deem the amount deposited with it insufficient, the Appropriate Grantor shall, upon demand, make an additional deposit of such sum as the Beneficiary may reasonably request, and upon failure so to do, the amount theretofore deposited may be applied to the payment, removal and discharge of the tax or other impositions and the interest and penalties in connection therewith, together with any costs, fees or other liabilities accruing. The balance, if any, shall be returned to the Appropriate Grantor, provided there is no then existing default under the Building Lease. Upon the termination of such proceedings, the Appropriate Grantor shall pay the amount of such tax or other claim as finally determined, together with any costs or other liabilities in connection therewith. Upon such payment, the Beneficiary shall return to the Appropriate Grantor the amount of any deposit above referred to, provided that there is no then existing default under the Building Lease.

ARTICLE VIII
COMPLIANCE WITH LAWS

SECTION 8.1. *Compliance.* The Grantors shall, with respect to the Property, promptly comply with all requirements of all laws, orders, ordinances, rules and regulations of the Federal, State, county and municipal authorities, and with any direction or certificate of occupancy of any public officer or officers, and the orders, rules and regulations of the National Board of Fire Underwriters and each other body having similar functions, and with requirements of all policies of public liability, fire, and other insurance at any time in force which shall impose any duty

with respect to all or any part of the Property or the use, occupation or control thereof or the conduct of any business therein, whether or not any of the same require structural repairs or alterations.

SECTION 8.2. *Contests.* The Appropriate Grantor shall not be required to comply with any such law, order, ordinance, rule, regulation, direction or certificate of occupancy (1) if the validity or legality thereof shall currently be contested in good faith by appropriate proceedings and (2) if it shall have furnished to the Beneficiary an Opinion of Counsel stating that noncompliance therewith pending the termination of such contest will neither cause any of the properties and interest which is included in the Property or any part thereof to be condemned or vacated, provided that all such proceedings shall be prosecuted with due diligence and dispatch, and further provided that the Appropriate Grantor shall furnish to the Beneficiary such security as it may reasonably require to preclude any loss or injury by reason of such noncompliance or delay therein.

ARTICLE IX
LIENS

SECTION 9.1. This Deed of Trust is, and always will be kept, a first lien upon the Property, subject only to the exceptions and limitations stated herein. The Grantors will not create or suffer to exist any lien or charge prior to or upon a parity with the lien of this Deed of Trust upon the Property or any part thereof, except as otherwise stated herein.

ARTICLE X
INSURANCE

SECTION 10.1. *Risks to be Insured.* At their expense, the Grantors shall:

A. keep the Property insured against loss or damage by fire and lightning and such other risks as are

insurable against under present or future standard forms of extended coverage insurance, in amounts not less than 100% of then full insurable value;

B. keep the Property insured against war risks as and when such insurance is obtainable from the United States of America or an agency thereof, in an amount not less than 100% of then full insurable value;

C. keep the Property insured in an amount not less than 10% of then full insurable value against loss or damage from leakage of sprinkler systems now or hereafter installed therein;

D. keep the Property insured against loss or damage from explosion of steam boilers, pressure vessels or similar apparatus with respect to all steam boilers, pressure vessels or similar apparatus now or hereafter installed upon the Property, in any amount not less than $100,000 with respect to any one accident; and

E. keep the Property insured as reasonably required by the Beneficiary and against all risks insured against by prudent persons owning like properties in like localities, giving due regard to the height and type of building, its construction, location, use and occupancy.

The term "full insurable value" shall mean the actual replacement cost (excluding foundation and excavation costs for the purposes of the foregoing Subsections A and C, but including such foundation and excavation costs for the purposes of the foregoing Subsection B), less physical depreciation, and said "full insurable value" shall be determined from time to time (but not more frequently than once in every 12 months period), at the request of the Beneficiary by an architect, contractor, appraiser, ap-

praisal company or one of the insurers selected and paid by the Grantors and acceptable to the Beneficiary.

All insurance for which provision has been made in Subsection E of this Section shall be maintained in such amounts as such insurance is usually carried by prudent persons engaged in the same or a similar business; and all insurance herein provided for shall be effected under a valid and enforceable policy or policies issued by insurers of recognized responsibility.

The policy or other contract of insurance in respect of the hazard of the character described in Subsection D of this Section may provide, in effect, that the first $1,000 of loss sustained shall be paid by the Appropriate Grantor and that additional losses sustained, which are insured against under such policy or other contract of insurance, shall be paid by the insurer.

All proceeds of insurance in respect of hazards of the character described in Subsection A, B, C, D and E of this Section covering any part of the Property (except in the case of any particular casualty resulting in loss payment not exceeding $50,000 in the aggregate) shall be paid to the Beneficiary. All policies or other contracts for such insurance shall provide that the proceeds of such insurance (except in the case of any particular casualty resulting in a loss payment not exceeding $50,000 in the aggregate) shall be payable to the Beneficiary as its interest may appear (by means of the standard mortgagee clause without contribution, if obtainable). All policies or certificates issued by the respective insurers for such insurance shall contain an agreement by such insurer that such policies shall not be cancelled without at least 10 days prior written notice to the Beneficiary. Upon the execution of this Deed of Trust and thereafter not less than 10 days prior to the expiration dates of expiring policies or contracts held by the Beneficiary, originals of all policies or contracts (or certified copies thereof or certificates there-

for) of insurance in respect of hazards of the character described in Subsections A, B, C, D and E of this Section shall be deposited with the Beneficiary. Within 30 days after each quarterly period ending on the last day of February, May, August and November of each year (commencing with the quarterly period ending February 28, 1970) the Appropriate Grantor will deliver to the Beneficiary an Officers' Certificate stating that, as to all such policies and contracts with respect to which the amount of premiums thereon shall have been determined and shall have become due and payable during such quarterly period, payment of all such premiums has been made.

Nothing in this Section shall prevent the Appropriate Grantor from taking out policies of blanket insurance, which may cover other property not included, as well as property included in the Property; provided, however, that the amount of the total insurance allocated to the buildings and fixtures constituting part of the Property (which amount shall at all times be not less than the applicable amount required by this Section) shall be specified either (1) in such policy of blanket insurance or (2) in a written statement obtained from the insurers under such policy, which written statement, in the case of insurance in respect of hazards of the character described in Subsections A, B, C, D and E of this Section, shall be deposited with the Beneficiary and provided, further, that in all other respects, any such policy shall comply with the other provisions of this Section.

Section 10.2. *Insurance Proceeds.* All proceeds of any insurance on the Property, to the extent that the same shall not be payable to the Beneficiary as aforesaid, shall be applied by the Appropriate Grantor to the repair, restoration or replacement of the property destroyed or damaged.

Proceeds of insurance on the Property or any part thereof, if payable to the Beneficiary, may be withdrawn and shall be paid by the Beneficiary upon Company Order

either as reimbursement for expenditures made to repair, restore or replace the property destroyed or damaged (which shall include expenditures made for temporary repairs or for the protection of property pending the completion of permanent repairs, restorations or replacements, or to prevent interference with the business operated thereon, and repair, restorations and replacements then in process insofar as actually made or constructed) or to pay contractors, subcontractors, materialmen, engineers, architects or other persons who have rendered services or furnished materials for such repairs, restorations or replacements, upon the receipt by the Beneficiary of the following:

A. An Officers' Certificate dated not more than 30 days prior to the application for the withdrawal of such proceeds, setting forth in substance as follows:

(1) That such funds are proceeds of insurance on a specified portion of the Property destroyed or damaged.

(2) That the sum then requested to be withdrawn either has been paid by the Appropriate Grantor and/or is justly due, to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered services or furnished materials for certain repairs, restorations or replacements to such portion of the Property, and giving a brief description of such services and materials and the principal subdivisions or categories thereof and the several amounts so paid and/or due to each of said persons in respect thereof, and stating the fair value of such repairs, restorations or replacements at the date of the acquisition thereof.

(3) That no part of such several amounts so paid and/or due has been or is being made the

basis for the withdrawal of any proceeds from the Beneficiary under this Deed of Trust in any previous or then pending application, or has been paid out of the proceeds of insurance not required to be paid to the Beneficiary.

(4) That, except for the amounts, if any, stated in said Officers' Certificate pursuant to the foregoing Clause (2) of this Subsection to be due for services or materials, there is no outstanding indebtedness known, after due inquiry, which is then due and payable for labor, wages, services, materials or supplies in connection with said repairs, restorations or replacements, which, if unpaid, might become the basis of a vendors', mechanics', laborers', materialmen's, statutory or other similar lien, upon said repairs, restorations, or replacements, or any party thereof, which might, in the opinion of the signers of said Officers' Certificate, materially impair the security afforded by said repairs, restorations or replacements.

(5) That no Event of Default, or other event which, with lapse of time or notice and lapse of time would become an Event of Default, has occurred which has not been remedied.

B. An Opinion of Counsel stating:

(1) That the Appropriate Grantor has acquired a good and valid legal title to all materials and all property constituting said repairs, restorations or replacements which are described in said Officers' Certificate, and that the same and every part thereof are free and clear of all mortgages, liens, charges or encumbrances prior to or on a parity with the lien of this Deed of Trust, except Permitted Encumbrances and encumbrances, if

any, securing indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said Officers' Certificate pursuant to the foregoing Subsection A(2), which encumbrances will be discharged upon payment of such indebtedness.

(2) That all of the Appropriate Grantor's right, title and interest in and to said repairs, restorations or replacements are then subject to the lien of this Deed of Trust.

Upon compliance with the foregoing provisions of this Section, the Beneficiary shall, out of such insurance proceeds, on Company Request pay to the persons named in said Officers' Certificate pursuant to the foregoing Subsection A(2) of this Section, the respective amounts stated in said Officers' Certificate to be due to them, and/or shall pay on Company Order the amount stated in said Officers' Certificate to have been paid, provided, however, that the aggregate amount of all such payments shall not exceed in total amount the fair value as stated in said Officers' Certificate of the relevant repairs, restorations or replacements.

This Section 10.2 shall not apply to a Total Destruction as defined in Section 12.3 hereof, and Section 17.6 of the Building Lease shall apply to the payment of insurance proceeds in such event.

SECTION 10.3 *Adjustment of Loss and Statement of Insurance in Force.* In case of any loss in respect of any of the Property covered by any policy or other contract of insurance, any adjustment and settlement of such loss which shall be agreed upon between the Appropriate Grantor and any insurer, as evidenced by an Officers' Certificate, shall be accepted by the Beneficiary; provided, however, that no adjustments or settlement in excess of

$200,000 shall be made unless the Beneficiary has consented thereto.

The Grantors will furnish to the Beneficiary, forthwith upon the execution of this Deed of Trust and within 40 days after the end of each fiscal year thereafter, and at any time upon the Beneficiary's reasonable request, an Officers' Certificate containing a statement of the insurance effected pursuant to this Article and then in force, and stating that said insurance complies with the covenants in this Article.

ARTICLE XI

ALTERATIONS AND ADDITIONS

SECTION 11.1. *Limitations on Building Demolition, Alterations, Improvements and New Construction.* The Grantors will not authorize, permit or make any demolition, alteration or improvement of any building, structure, or other improvements included in the Property or any new construction on any part of the Property, except, as to any such alteration, improvement or new construction, in conformity with and subject to the limitations hereinafter in this Section set forth.

Unless an Event of Default shall have occurred which shall not have been remedied, the Grantors shall have the right (subject to Article XV of the Building Lease) at all times to make or permit alterations, improvements or new construction, structural or otherwise, of or on the Property, including, without limiting the generality of the foregoing, the right to connect any building included in the Property with any adjoining building or buildings or part thereof if the building with which any such connection is made is also a part of the Property. Such alterations, improvements or new construction (herein sometimes collectively called "changes and alterations" or "changes or alterations") shall be made in all cases subject to the following conditions:

A. No change or alteration shall be undertaken or carried on until there shall have been procured and paid for, so far as the same may be required from time to time, all municipal and other governmental permits and authorizations of the various municipal departments and governmental subdivisions havings jurisdiction, which are requisite for the completion of such change or alteration.

B. The building or buildings as so improved or altered, upon completion of the work, shall be of a value not less than the value of such building or buildings immediately prior to the making of such improvement or alterations.

C. Any change or alteration involving an estimated cost of more than $100,000 shall be conducted under the supervision of an architect or engineer selected by the Appropriate Grantor, and who shall be satisfactory to the Beneficiary, and no such change or alteration shall be undertaken until 20 days after there shall have been filed with the Beneficiary detailed plans and specifications and cost estimates therefor, prepared and approved in writing by such architect or engineers and accompanied by a certificate of such architect or engineer stating that such plans and specifications conform to all applicable provisions of this Section.

D. No change or alteration involving an estimated cost of more than $250,000 shall be undertaken until either

(1) the Beneficiary shall have been furnished with a bond, on which the Appropriate Grantor shall be principal and a surety company of recognized responsibility shall be surety, and in form satisfactory to the Beneficiary, conditioned upon the completion of any payment in full for such

change or alteration within a reasonable time, subject to Unavoidable Delays, or

(2) the Appropriate Grantor shall have deposited or caused to be deposited with the Beneficiary an amount of money equal to said estimated cost;

E. Moneys deposited with the Beneficiary pursuant to Clause (2) of the foregoing Subsection D may be withdrawn by the Appropriate Grantor, and shall be paid by the Beneficiary as hereinafter provided from time to time, upon receipt by the Beneficiary of the following:

(1) an Officers' Certificate, dated not more than 30 days prior to the application for such withdrawal, and signed also (except as to Subclauses (c) and (e) of this Clause) by the architect or engineer referred to in Subsection C of this Section, setting forth in substance as follows:

(a) That the sum then requested to be withdrawn either has been paid by the Appropriate Grantor, and/or is justly due, to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered services or furnish materials for any such change or alteration pursuant to the plans and specifications therefor previously filed with the Beneficiary pursuant to Subsection C of this Section, and giving a brief description of such services and materials and the principal subdivisions or categories thereof, and the several amounts so paid or due to each of said persons in respect thereof, and stating the progress of such change or alteration pursuant to said plans and specifications up to the date of said Officers' Certificate, and that, so far as they are

applicable to the conduct of such change or alteration, Subsections A and G of this Section have been fully complied with.

(b) That the sum then requested to be withdrawn from the Beneficiary on account of account of such change or alteration, does not exceed the total cost thereof insofar as actually accomplished up to the date of said Officers' Certificate, and that in the opinion of the signers the remaining moneys so deposited with the Beneficiary will be sufficient to pay in full for the completion of such change or alteration.

(c) That no part of such several amounts so paid and/or due has been or is being made the basis of the withdrawal of any moneys from the Beneficiary under this Deed of Trust, in any previous or then pending application, or has been paid out of the proceeds of insurance not required to be paid to the Beneficiary hereunder.

(d) That, except for the amounts, if any, stated in said Officers' Certificate, pursuant to Subclause (a) of this Clause, to be due for services or materials, there is no outstanding indebtedness known, after due inquiry, to the Appropriate Grantor which is then due and payable for labor, wages, services, materials or supplies in connection with such change or alteration which, if unpaid, might become the basis of a vendors', mechanics', laborers', materialmen's, statutory or other similar lien, upon such change or alteration, or any part thereof, which might, in the opinion of the signers of said Officers' Certificate, materially impair the security afforded by such change or alteration.

(e) That no Event of Default has occurred which has not been remedied.

The statements contained in said Officers' Certificate pursuant to this Clause may be based upon information furnished to the Company by the Bank pursuant to the Building Lease.

(2) An Opinion of Counsel stating:

(a) That the Appropriate Grantor has a good and valid legal title to all materials and all property constituting such change or alteration which are described in said Officers' Certificate, free and clear of all mortgages, liens, charges or encumbrances prior to or on a parity with the lien of this Deed of Trust, except Permitted Encumbrances, and encumbrances if any, securing indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said Officers' Certificate pursuant to the foregoing Clause (1) (a) of this Subsection, which encumbrances will be discharged upon payment of such indebtedness.

(b) That all of the Appropriate Grantor's right, title and interest in and to the property constituting such change or alteration is then subject to the lien of this Deed of Trust.

Upon compliance with the foregoing provisions of this Subsection, the Beneficiary shall pay to the persons named in said Officers' Certificate pursuant to Subclause (a) of said Clause (1) the respective amounts stated in said Officers' Certificate to be due to them and/or shall pay on Company Order the amount stated in said Officers' Certificate to have been paid by the Company or the Bank.

F. At any time after the completion in full, pursuant to the plans and specifications therefor previously filed with the Beneficiary under Subsection C of this Section, of any change or alteration in respect whereof such moneys were deposited, the whole balance of moneys so deposited with the Beneficiary and then remaining on deposit may be withdrawn by the Appropriate Grantor and shall be paid by the Beneficiary upon Company Order, upon receipt by the Beneficiary of an Officers' Certificate, dated not more than 5 days prior to the application for such withdrawal, and signed also (except as to Clauses (3) and (4) of this Subsection) by the architect or engineer referred to in Subsection C of this Section setting forth in substance as follows:

(1) That such change or alteration in respect of which such moneys were deposited has been completed in full pursuant to the plans and specifications therefor previously filed with the Beneficiary under Subsection C of this Section.

(2) That all amounts which the Appropriate Grantor is or may be entitled to withdraw under Subsection E of this Section on account of services rendered or materials furnished in connection with such change or alteration have been withdrawn under said Subsection E.

(3) That all amounts for whose payment the Appropriate Grantor is or many become liable in respect of such change or alteration have been paid in full.

(4) That no Event of Default, or other event which, with lapse of time or notice and lapse of time, would become an Event of Default, has occurred which has not been remedied.

The statements contained in said Officers' Certificate pursuant to this Subsection may be based upon infor-

mation furnished to the Company by the Bank pursuant to the Building Lease.

G. All work done in connection with any change or alteration shall be done promptly and in good and workmanlike manner and in compliance with the building and zoning laws of the municipality or other governmental subdivision wherein the Property is situated, and with all laws, ordinances, orders, rules, regulations and requirements of all federal, state and municipal governments and the appropriate departments, commissions, boards and officers thereof, and in accordance with the orders, rules and regulations of the National Board of Fire Underwriters, or any other body now or hereafter constituted exercising similar functions; the work in connection with any change or alteration shall be prosecuted with reasonable dispatch, Unavoidable Delays excepted.

ARTICLE XII

DAMAGE TO OR DESTRUCTION OF PROPERTY

SECTION 12.1. *Notice.* In case of any material damage to or destruction of the Property or any part thereof, the Grantors will promptly give written notice thereof to the Beneficiary, generally describing the nature of such damage or destruction.

SECTION 12.2. *Restoration.* In case of any damage to or destruction of the Property or any part thereof other than a Total Destruction (as defined in Section 17.6 of the Building Lease), the Grantors will (whether or not the insurance proceeds, if any, on account of such damage or destruction shall be sufficient for the purpose) promptly commence and complete (subject to Unavoidable Delays) the restoration, replacement or rebuilding of the Property as nearly as possible to its value, condition and character immediately prior to such damage or destruction, with such alterations and additions as may be made pursuant to and subject to the

conditions of Article XI (such restoration, replacement, rebuilding, alterations and additions, together with any temporary repairs and property protection pending completion of the work, being herein called "Restoration").

SECTION 12.3. *Total Destruction.* In case of Total Destruction (as defined in Section 17.6 of the Building Lease) of the Company Improvements, the Company will, within 5 days after receipt of the notice provided therein, furnish or cause the Bank to furnish a copy of such notice to the Beneficiary. Section 10.2 hereof shall not apply to a Total Destruction, and Section 17.6 of the Building Lease shall apply in lieu thereof. If the Company shall fail to comply with Section 17.6 of the Building Lease, the Trustee is hereby irrevocably appointed the agent and attorney-in-fact of the Company and of each future owner of the Company Property in order to comply with such provisions, including, without limitation, the execution and delivery, in the name of and on behalf of the Company or other owner of the Company Property, of a deed, bill of sale and/or other instrument of conveyance of the Company Property to the Bank, but such appointment shall not prevent any failure on the part of the Company or the Bank to comply with the terms of this Section from constituting a default under this Deed of Trust.

ARTICLE XIII

TAKING OF PROPERTY

SECTION 13.1. *Notice; Assignment of Awards, etc.* In case of a Taking of all or any part of the Property, or the commencement of any proceeding or negotiations which might result in any such Taking, the Grantors will promptly give written notice thereof to the Beneficiary, generally describing the nature and extent of such Taking or the nature of such proceedings or negotiations and the nature and extent of the Taking which might result therefrom, as the case may be. The Grantors hereby irrevocably assign, transfer, and

set over to the Beneficiary all of their rights to any award or payment on account of any Taking. Should all or any part of the Property be taken by eminent domain (other than a Taking by eminent domain for governmental occupancy for a limited period as set forth in Section 18.7 of the Building Lease), the Grantors forthwith, upon receipt, shall deposit the award for such property so taken with the Beneficiary and any amount paid by the Bank pursuant to Section 18.1 of the Building Lease. In the event of any such Taking, the Beneficiary shall release the property so taken, but only upon receipt by and deposit with the Beneficiary of the following:

A. The amount of the award for said property and any amount payable by the Bank pursuant to Section 18.1 of the Building Lease.

B. An Opinion of Counsel stating:

(1) That such property has been taken by eminent domain.

(2) That the award for the property so taken has become final or that an appeal from such award is not advisable in the interests of the Company or the Beneficiary.

All moneys received by the Beneficiary as compensation for the whole or any part of the Property taken by eminent domain, and all moneys paid by the Bank pursuant to Section 18.1 of the Building Lease shall be held by the Beneficiary as a part of the Trust Estate, and upon any sale of the Trust Estate, or any part thereof, said funds shall be applied, with the proceeds of such sale, to the payment of all sums hereby; but prior to any such sale, all or any part of the said funds may be withdrawn and shall be paid over or applied by the Beneficiary from time to time as provided in Section 13.4 hereof.

SECTION 13.2 *Partial Taking.* In case of a Taking of the Property other than Total Taking (as defined in Section 13.3 hereof), the Grantors will (whether or not the awards or payments, if any, on account of such Taking shall be sufficient for the purpose) promptly commence and complete (subject to Unavoilable Delays) Restoration of the Property as nearly as possible to its value, condition and character immediately prior to such Taking, except for any reduction in area caused thereby, provided that in case of a Taking for a limited period of the character described in Section 18.7 of the Building Lease the Grantors shall not be required to effect Restoration until such Taking is terminated.

SECTION 13.3 *Purchase.* In case of a Taking of the Property resulting in termination of the Building Lease pursuant to Section 18.1 thereof or resulting in purchase of the Company Property by the Bank pursuant to Section 18.2 of the Building Lease ("Total Taking"), the Company will, within 5 days after receipt of the Bank's notice of termination (if any) or purchase, furnish or cause the Bank to furnish a copy thereof to the Beneficiary. If the Company shall fail to comply with Section 18.4 of the Building Lease, the last sentence of Section 12.3 hereof shall apply.

SECTION 13.4 *Application of Awards.* All awards and payments received by or payable to the Beneficiary on account of a Taking of all or any part of the Property (less the actual costs, fees and expenses incurred in the collection thereof) shall be applied or dealt with by the Beneficiary as follows:

A. All such awards and payments received on account of a Taking of the Property other than a Total Taking (as defined in Section 13.3 hereof) may be withdrawn and shall be paid by the Beneficiary upon Company Order either to reimburse the Company or the

Bank for expenditures made to repair or restore the Property affected by any such Taking (which include expenditures made for temporary repairs or for the the protection of property ending the completion of prmanent repairs, restorations and replacements, or to prevent interference with the business operated thereon, and repairs, restorations and replacements then in process insofar as actually made or constructed) or to pay contractors, subcontractors, materialmen, engineers, architects or other persons who have rendered services or furnished materials for said repairs, restorations or replacements, upon receipt by the Beneficiary of the following:

(1) An Officers' Certificate, dated not more than 30 days prior to the application for the withdrawal of such funds and signed also as to Clause (b) of this Subsection (1) by an architect or engineer selected by the Bank or the Company, who may be in the employ of the Company or the Bank and shall be acceptable to the Beneficiary, setting forth in substance the following:

(a) That specified funds are proceeds of an award for the Taking by eminent domain of a specified part of the Property.

(b) That, in the opinion of said architect or engineer and of the Company or the Bank, the injury, damage and loss from such Taking have been or can be so repaired, restored or replace that the remaining portion of the Property can be effectively used in the business of the Company or the Bank.

(c) That the sum then requested to be withdrawn has been paid by the Company or the Bank, and/or is justly due, to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered services or furnished materials for certain repairs, restorations or replacements, and giving a brief description of such services and materials and the principal subdivisions or categories thereof and the several amounts so paid and/or due to each of said persons in respect thereof, and also stating the fair value to the Company or the Bank of such repairs, restorations or replacements at the time of acquisition thereof by the Company or the Bank.

(d) That no part of such several amounts so paid and/or due has been or is being made the basis for the withdrawal of any funds from Beneficiary under this Deed of Trust, in any previous or then pending application, or has been paid out of the proceeds of insurance not required to be paid to the Beneficiary under Article X.

(e) That, except for the amounts, if any, stated in said Officers' Certificate pursuant to (1) to be due for services or materials, there the foregoing Clause (c) of this Subsection is no outstanding indebtedness known, after due inquiry, to the Company or the Bank which is then due and payable for labor, wages, services, materials, or supplies in connection with said repairs, restorations or replacements, which, if unpaid, might become the basis of a vendors', mechanics', laborers', materialmen's statutory or other similar lien, upon the Property or any part thereof, which might, in the opinion of the signers of said Officers' Certificate, materially impair the security afforded by the Property.

(f) That no Event of Default, or other event which, with the lapse of time or the notice and lapse of time specified in Section 17.1, would become an Event of Default, has occurred which has not been remedied.

The statements contained in said Officers' Certificate pursuant to this Subsection may be based upon information furnished to the Company by the Bank pursuant to the Building Lease.

(2) An opinion of Counsel stating:

(a) That the Company or the Bank has acquired a good and valid legal title to all materials and all property constituting said repairs, restorations or replacements which are described in said Officers' Certificate, and that the same and every part thereof are free and clear of all mortgages, liens, charges or encumbrances prior to or on a parity with the lien of this Deed of Trust, *except* Permitted Encumbrances and encumbrances, if any, securing indebtedness due to persons (whose names and addresses and the several amounts due them shall be stated) specified in said Officers' Certificate pursuant to the foregoing Subsection (1)(c), which encumbrances will be discharged upon payment of such indebtedness.

(b) That all of the Grantors' right, title and in and to said repairs, restorations or replacements are then subject to the lien of this Deed of Trust.

Upon compliance with the foregoing provisions of this Section the Beneficiary shall out of funds of the character aforesaid, on Company Request pay to the persons named

in said Officers' Certificate pursuant to the foregoing Subsection (1)(c) of this Section, the respective amounts stated in said Officers' Certificate to be due to them, and/or shall pay on Company Order the amount stated in said Officers' Certificate to have been paid by the Company or the Bank; *provided, however,* that the aggregate amount of all such payments shall not exceed in total amount the fair value as stated in said Officers' Certificate of the relevant repairs, restorations or replacements.

B. All such awards and payments received or payable on account of a Total Taking shall be paid or applied as provided in Section 18.4 of the Building Lease.

ARTICLE XIV

Undisbursed Proceeds or Awards

Section 14.1 Any insurance proceeds, the payment of which is subject to Section 10.2 hereof and which are not disbursed by the Beneficiary upon Company Order or Request pursuant thereto, and any award, the payment of which is subject to Section 13.4A and which is not disbursed by the Beneficiary upon Company Order or Request pursuant thereto, shall be paid by the Beneficiary to the Bank, provided that at the time of such payment there exists no default in the performance of any of the terms, covenants or conditions of this Deed of Trust or of the Building Lease.

ARTICLE XV

Maintenance of Corporate Existence

Section 15.1. The Company will maintain, preserve and keep in full force and effect its corporate existence, rights and privileges in the State of Arkansas until the Note has been paid in full or until the Bank has assumed the indebtedness (in compliance with applicable provisions of

the Building Lease) due under the Note, whichever shall first occur.

ARTICLE XVI

Advances by Beneficiary

Section 16.1. If either the Company or the Bank shall fail to perform any of its covenants in this Deed of Trust, the Beneficiary may, at any time and from time to time, in its discretion, make advances to effect performance of any such covenant on behalf of the Company or the Bank; and all such moneys advanced by the Beneficiary, together with interest at the rate of 10% per annum, shall be repaid by the Company or the Bank, as the case may be, upon demand and shall be secured under this Deed of Trust, but no such advance shall relieve the Company or the Bank, as the case may be, from any default hereunder.

ARTICLE XVII

Remedies

Section 17.1. *"Events of Default" Defined; Acceleration of Maturity.* In case one or more of the following "Events of Default" shall happen and shall not have been remedied, that is to say:

A. default shall be made in the payment of any interest on the Note when the same shall become due and payable, and such default shall continue for a period of 10 days after written notice thereof shall have been given to the Grantors by the Beneficiary; or

B. default shall be made in the payment of the principal of, or any premium on, the Note when the same shall become due and payable and such default shall continue for a period of 10 days after written notice thereof shall have been given to the Grantors by the Beneficiary; or

C. the Building Lease shall have terminated for any reason (other than as permitted therein); or

D. default shall be made in the performance of any covenant hereunder or in the Assignment; or

E. default shall be made in the performance of any covenant or warranty in the Note Purchase Agreement or in the Consent and Agreement of the Bank, and such default shall continue for a period of 30 days after written notice thereof, specifying such default and requiring the same to be remedied, shall have been given to the Grantors by the Beneficiary; or

F. the Company (or the Bank in the event of an assumption of the indebtedness due under the Note in compliance with applicable provisions of the Building Lease) shall

(1) apply for, or consent in writing signed on behalf of its officers or its duly authorized attorney to, the appointment of a receiver, trustee or liquidator of all or a substantial part of its assets; or

(2) file a voluntary petition in bankruptcy, or admit in writing its inability to pay its debts as they become due; or

(3) make a general assignment for the benefit of creditors; or

(4) file a petition or an answer seeking reorganization or arrangement with creditors or to take advantage of any insolvency law; or

(5) file an answer admitting the material allegations of or consent to, or default in answering a petition filed against it in any bankruptcy, reorganization or insolvency proceeding; or

G. an order, judgment or decree shall be entered by any court of competent jurisdiction, on the application of a creditor, adjudicating the Company (or the Bank in the event of an assumption of the indebtedness due under the Note in compliance with applicable provisions of the Building Lease) insolvent or approving a petition seeking reorganization or appointing a receiver, trustee or liquidator of all or a substantial part of its assets, and such order, judgment or decree shall continue unstayed and in effect for any period of 60 consecutive days;

then and upon each and every such Event of Default, the entire indebtedness secured by this Deed of Trust shall be and become immediately due and payable at the option of the Beneficiary, and the Beneficiary may enforce any appropriate remedy against the Grantors and proceed by suit to foreclosure or by suits at law or in equity, as the Beneficiary may elect, to enforce payment of all sums secured hereby. Without limiting the generality of the foregoing, the Beneficiary may, to the extent permitted by law, in case one or more of the Events of Defaults shall happen and shall not have been remedied, enter into and uplon all or any part of the Property (including the books, papers and accounts of the Company and the Bank relating to the Property), and may exclude the Company, and the ly or partly therefrom; and, holding the same, the Bene- Bank, and all persons claiming under either of them, whol- ficiary may use, operate, manage and control the Property and conduct the business thereof, and exercise all rights and powers of the Company, including all the rights, powers and remedies conferred upon or reserved to the Company, as lessor, by the Building Lease, either in the name of the Company or otherwise, as the Beneficiary shall deem best. Upon every such entry, the Beneficiary may collect the rents, issues, profits, revenues and other income of the Property and apply the same, after payment

of all necessary charges and expenses, to the payment of all sums secured hereby. Also, without limiting the generality of the foregoing, the Beneficiary may, to the extent permitted by law, exercise the power of sale herein provided for. Any sale of the Property pursuant to such power of sale shall be held on the property or, to the extent permitted by law, at such place as shall be fixed by the Beneficiary in the notice of sale.

SECTION 17.2. *Waiver of Redemption, etc.; Rights.* To the full extent that they may lawfully do so, the Company and the Bank hereby waive any and all rights of redemption from any sale under any order or decree of foreclosure of this Deed of Trust or under the power of sale herein provided for, each on its own respective behalf and also on behalf of each and every person acquiring any interest in or title to the Property subsequent to the date of this Deed of Trust, particularly (but without limitation) redemption under the Act of the General Assembly of the State of Arkansas, entitled "An Act to Regulate the Foreclosure of Mortgages," approved February 9, 1933.

To the full extent that they may lawfully so agree, neither the Company nor the Bank will at any time insist upon, plead, claim, or take the benefit or advantage of any appraisement, valuation, stay or extension law now or hereafter in force, in order to prevent or hinder the enforcement of this Deed of Trust or the absolute sale of the Property, of any part thereof, or possession thereof by any purchaser, at any sale under this Deed of Trust. The Grantors also waive, to the extent that they lawfully may, all right to have the property, included in the Property, marshalled upon any foreclosure hereof, and agree that any court having jurisdiction to foreclose this Deed of Trust may order the sale of the Property as an entirety.

If any law in this Section referred to and now in force, of which the Grantors or their successors might take ad-

vantage despite this Section, shall hereafter be repealed or cease to be in force, such law shall not thereafter be deemed to constitute any part of the contract herein contained or to preclude the application of this Section.

Section 17.3. *Purchase by Beneficiary.* The Beneficiary, or the then holder of the indebtedness secured hereby may become the purchaser at any sale of the Trust Estate or any part thereof or interest therein, whether such sale is pursuant to foreclosure or power of sale or otherwise.

Section 17.4. *Building Lease Options.* Any sale of the Company Property, or part thereof, whether such sale is pursuant to foreclosure or power of sale or otherwise, shall be subject to the Building Lease; provided, however, that any such sale shall constitute a perpetual bar to any and all rights or options of the Lessee in said lease to purchase the Company Property, or part thereof, and the Bank, as Lessee in said lease, specifically agrees that the purchaser at such sale shall acquire the Company Property, or part thereof purchased, free and clear of any and all such rights and options.

ARTICLE XVIII

Power of Sale

Section 18.1. Upon an Event of Default, the Trustee may sell, assign, transfer and deliver the whole or any part of the Trust Estate or any interest in any part thereof at any private sale or at public auction, with or without demand, advertisement or notice of the time or place of sale or adjournment thereof or otherwise, for cash, on credit, or for other property at such price or prices and on such terms as the Trustee in his uncontrolled discretion may determine. The Grantors irrevocably appoint the Trustee as their true and lawful attorney to act in their name for the purpose of effectuating any sale, assignment, transfer or delivery for the enforcement of this Deed of Trust,

whether pursuant to foreclosure or power of sale or otherwise, to execute and deliver all such deeds and other instruments as the Trustee may consider necessary. The Beneficiary may be a purchaser of the Trust Estate or any part thereof at any such sale and may apply upon the purchase price the indebtedness secured hereby owing, and any such purchaser shall thereby acquire good title to the property purchased.

ARTICLE XIX

Application of Proceeds of Sale

Section 19.1. The proceeds of any sale of the Trust Estate or any part thereof or interest therein, whether pursuant to foreclosure or power of sale or otherwise, together with any other money at the time held by the Trustee as part of the Trust Estate, shall be applied to pay:

First: The costs and expenses of the sale and of any receiver of the Trust Estate.

Second: Any indebtedness secured by this Deed of Trust and at the time due and payable, other than indebtedness with respect to the Note.

Third: All amounts of principal, premium, if any, interest and other amounts at the time due and payable on the Note; and if such funds shall be insufficient to pay in full the amount so due and unpaid on the Note, then first to the payment of interest thereon, second to the payment of principal and premium, if any, at the time due and payable thereon, and third to the payment of any other amounts at the time due and payable on the Note.

Fourth: The balance shall be paid seventy-five (75%) per cent to the Company, its successors and assigns, and twenty-five (25%) per cent to the Bank, its successors and assigns.

ARTICLE XX

Company Obligations with Respect to Building Lease

Section 20.1. The Company shall perform or cause to be performed all of the terms, covenants and conditions on its part as Lessor to be performed under the Building Lease; shall promptly notify the Beneficiary in writing of (1) the occurrence of any default, of which the Company has knowledge, on the part of the Bank in the observance of or performance of any of the terms, covenants, and conditions on the Bank's part to be performed under the Building Lease, and (2) the giving of any notice of default under the Building Lease by the Company as provided therein; and shall, whenever requested by the Beneficiary, at the sole cost and expense of the Company, take all such action as may be so requested to enforce or secure the performance of any term, covenant or condition of the Building Lease to be performed by the Bank, and to exercise any right of the Company as Lessor under the Building Lease, or create or consent to the creation or existence of any mortgage, deed of trust or other lien to secure the payment of indebtedness upon the leasehold estate created by the Building Lease, or any part thereof, unless the Beneficiary consents thereto, or unless specifically permitted therein.

ARTICLE XXI

Cost of Collection

Section 21.1 If the Company shall fail to pay any principal of or premium, if any, or interest on the Note, the Company shall pay the Beneficiary such further amount as shall be sufficient to cover the cost and expense of collection, including, reasonable attorneys' fees to the extent permitted by law.

ARTICLE XXII

No Waiver

Section 22.1 Neither failure nor delay on the part of the Beneficiary or the Trustee to exercise any right, remedy, power or privilege provided for herein or by statute or at law or in equity or otherwise shall operate as a waiver thereof, nor shall any single or partial exercise of any such right, remedy, power or privilege preclude any other or further exercise thereof or the exercise of any other right, remedy, power or privilege.

ARTICLE XXIII

Release

Section 23.1. If the Company shall pay the principal of and premium, if any, and interest on the Note in accordance with the terms thereof and all other sums payable hereunder by the Company and shall comply with all of the terms hereof and of the Note, then this Deed of Trust shall be null and void and of no further force and effect and shall be released by the Trustee at the expense of the Grantors upon their written request.

ARTICLE XXIV

General Provisions

Section 24.1 *Successors.* All the covenants and provitions in this Deed of Trust by or for the benefit of the parties hereto shall bind and inure to the benefit of their respective successors and assigns.

Section 24.2. *Applicable Law.* This Deed of Trust shall be construed and enforceable in accordance with the laws of the State of Arkansas.

Section 24.3. *Counterparts.* This Deed of Trust may be executed in any number of counterparts, and each of

such counterparts shall for all purposes be deemed to be an original, and all such counterparts shall together constitute but one and the same instrument.

SECTION 24.4. *Headings.* The headings in this Deed of Trust are for purposes of reference ony and shall not limit or define the meaning hereof.

IN WITNESS WHEREOF, the Grantors have caused this Deed of Trust to be duly executed, all as of the day and year first above written.

FRANK LYON COMPANY

By .....
President

Attest:

.....
Secretary

WORTHEN BANK & TRUST COMPANY

By .....
President

Attest:

.....
Secretary

TRUSTEE:

.....
Darrell D. Dover

(Acknowledgements Omitted in Printing)

SCHEDULE I OF DEED OF TRUST

The land referred to as Tract A in the Deed of Trust dated as of December 1, 1969, between Worthen Bank & Trust Company and Frank Lyon Company as Grantors and Darrell D. Dover as Trustee, to which this Schedule I is attached, consists of a parcel of land in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

> BEGINNING at the Southwest corner of Lot 6, Block 84, Original City of Little Rock; thence northerly 160.33 feet along the West side of Lots 6, 5, 4 and 3 to a point 139.67 feet South of the Northwest corner of said Block 84; thence easterly 140.0 feet to a point on the East side of Lot 3, located 139.67 feet South of the Northeast corner of Lot 1; thence 43.88 feet in a southerly direction along the East side of Lots 3 and 4; thence easterly 160.0 feet to a point on the East side of Lot 9, located 116.45 feet North of the Southeast corner of Lot 7; thence southerly 116.45 feet along the East side of Lots 9, 8 and 7 to the Southeast corner of Lot 7; thence westerly 300.0 feet long the South side of Lots 7 and 6 to the point of beginning,

Subject, however, to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of City of Little Rock Arkansas, to Worthen Bank & Trust Company.

LESS AND EXCEPT —

(a) the air space above the North 29.33 feet of Tract A beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding,

however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Bank & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

SCHEDULE II OF DEED OF TRUST

The land referred to as Tract B in the Deed of Trust dated as of December 1, 1969, between Frank Lyon Company and Worthen Bank & Trust Company as Grantors and Darrell D. Dover as Trustee, to which this Schedule II is attached, consists of a parcel of land in Little Rock, Pulaski County, Arkansas, and is more particularly described as follows:

BEGINNING at the Northwest corner of Lot 1, Black 84, Original City of Little Rock; thence easterly 140.0 feet along the North side of Lot 1 to the Northeast corner of Lot 1; thence southerly 139.67 feet along the East side of Lots 1, 2, and 3; thence westerly 140.0 feet to a point on the West side of Lot 3, located 139.67 feet south of the Northwest corner of Lot 1, thence northerly 139.67 feet along the west side of Lots 3, 2 and 1 to the point of beginning;

SUBJECT, HOWEVER, To a perpetual surface easement for use by the public as a passageway, described in an Agreement between Worthen Bank & Trust Company and Union National Bank of Little Rock, Trustee, and Charles M. Taylor, Trustee, dated April 14, 1967, and recorded July 5, 1967, in Book 1001 at Pages 187-194, inclusive, of the records of the Circuit Clerk of Pulaski County, Arkansas, and further described in an Agreement dated July 26, 1967, filed for record August 2, 1967, and recorded in Book 1004 at Page 515 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by and between Worthen Bank & Trust Company and Union National Bank of Little Rock and William L. Terry, as Co-Trustees under "The Terry Trust," and Adolphine Fletcher Terry; said easement covering the north 20 feet of the South 25.17 feet of Tract B plus the turning radius described in said Agreement.

Further subject to certain restrictions, conditions and reservations contained in a Special Warranty Deed dated September 15, 1967, filed for record September 15, 1967, and recorded in Book 1009 at Page 537 of the records of the Circuit Clerk of Pulaski County, Arkansas, executed by Housing Authority of City of Little Rock, Arkansas, to Worthen Bank & Trust Company.

TOGETHER WITH —

(a) the air space above the North 29.33 feet of Tract A (described in Schedule I hereof) beginning at an elevation of 318.23 feet above sea level and extending upward therefrom; excluding, however, the portion of said air space to be occupied by the elevator shaft and stair well shown on the plans and specifications for construction of the improvements on Tract A, prepared by the architectural firm of Erhart, Eichenbaum, Rauch & Blass of Little Rock, Arkansas, and

(b) an easement retained by Worthen Banuk & Trust Company, its successors and assigns forever, upon the North 29.33 feet of Tract A to construct, repair and replace structural supports, columns or foundations thereon, together with the right of ingress and egress for such purposes; provided that Worthen Bank & Trust Company (or its successor in interest) shall repair any damage to improvements on Tract A as a result of the use of this easement and shall indemnify Frank Lyon Company (or its assignee) against any loss or damage caused by the use of this easement.

P. Ex. 28

ASSIGNMENT

This Assignment, dated as of December 1, 1969, is made by Frank Lyon Company, an Arkansas corporation (hereafter called the "Assignor"), having its principal office at West 65th Street and Scott Hamilton Drive, Little Rock, Arkansas, to New York Life Insurance Company, a New York corporation (hereafter called the "Assignee"), having its principal office at 51 Madison Avenue, City, County and State of New York.

For value received, the Assignor hereby grants, bargains, sells, sets over, transfers and assigns to Assignee, its successors and assigns, all of the right, title and interest of the Assignor to Lessor in, to and under that certain lease as of May 1, 1968 (the "Building Lease"), between the Assignor as Lessor and Worthen Bank & Trust Company of Little Rock, Arkansas, as Lessee covering, among other things, (i) all buildings, structures and other improvements now or hereafter located on certain real property referred to therein as Tract A and described in Schedule I thereto, together with all fixtures thereon, and (ii) the interest of the Assignor as Lessee in, to and under that certain lease dated as of May 1, 1968, (the "Ground Lease"), between Worthen Bank & Trust Company as Lessor and the Assignor as Lessee, covering Tract A described in said lease. The Building Lease is recorded at Book 1213, Page 281, of the records of the Circuit Clerk of Pulaski County, Arkansas. The Ground Lease is recorded at Book 1213, Page 325, of the records of the Circuit Clerk of Pulaski County, Arkansas.

The foregoing Assignment is for the purpose of securing (a) payment of all sums now or at any time hereafter due to the Assignee and secured by a certain deed of trust dated as of December 1, 1969, (hereinafter called the "Deed of Trust"), executed by the Assignor and Worthen

Bank & Trust Company, as Grantors to a trustee for the benefit of the Assignee and to be recorded immediately after the recording of this Assignment, and (b) performance and discharge of each obligation, covenant and agreement of the Assignor contained herein or in the Deed of Trust or the secured promissory note referred to in and secured by the Deed of Trust.

Except as and to the extent that the Assignee may from time to time otherwise direct, the Assignor hereby irrevocably directs Worthen Bank & Trust Company to pay to the Assignee all installments of Basic Rent and all Additional Rent payable under the Building Lease.

The Assignee agrees that upon the payment in full of all indebtedness secured hereby, as evidenced by the recording or filing of an instrument of satisfaction or full release of the Deed of Trust, this Assignment shall become and be void and of no effect.

The Assignor agrees that:

1. The Assignor will:

(a) perform or cause to be performed all of the terms, covenants and conditions on its part to be performed under the Building Lease;

(b) promptly notify the Assignee in writing of the occurrence of any default, of which the Assignor has knowledge, in the observance or performance of any of the terms, covenants and conditions to be performed under the Building Lease, and the giving of any notice of default under such lease;

(c) whenever requested by the Assignee, at the sole cost and expense of the Assignor, take all such action as may be so requested to enforce or secure the performance of any term, covenant or condition of the Building Lease, and to exercise any right of the Assignor under said lease;

(d) not terminate (except as permitted pursuant to Article XX of the Building Lease), modify or accept a surrender of, or offer or permit any termination, modification or surrender of, the Building Lease, unless the Assignee consents in writing thereto.

2. The rights assigned hereunder include all the Assignor's right and power to modify the Building Lease or to terminate (except as permitted pursuant to Article XX of the Building Lease) or accept a surrender of said lease or to waive or release any person from the performance or observance of and obligation or condition thereof.

3. If the Assignor shall fail to perform any of its covenants in this Assignment the Assignee may at any time and from time to time at its discretion makes advances to effect performance of any such covenant on behalf of the Assignor, and all such moneys advanced by the Assignee, together with interest at the rate of ten per cent (10%) per annum, shall be repaid by the Assignor upon demand and shall be secured hereby and by the Deed of Trust but no such advance shall relieve the Assignor from defaults hereunder.

4. The Assignee may, to the extent permitted by law, in case one or more of the Events of Default described in the Deed of Trust shall happen and shall not have been remedied, enter into and upon all or any part of the premises covered under the Building Lease and may exclude the Assignor and all persons claiming under the Assignor, wholly or partly therefrom; and holding the same, the Assignee may use, operate, manage and control said premises and conduct the business thereof, and exercise all rights and powers of the Assignor, including all the rights, powers and remedies conferred upon or reserved to the Assignor by the Building Lease, either in the name of the Assignor or otherwise, as the Assignee shall deem best.

5. The Assignee shall not be obligated to perform or discharge any obligation under the Building Lease or under or by reason of this Assignment, and the Assignor hereby agrees to indemnify the Assignee against and hold it harmless from any and all liability, loss or damage which it may or might occur under said lease or under or by reason of this Assignment and of and from any and all claims and demands whatsoever which may be asserted against it by reason of any alleged obligation or undertaking on its part to perform or discharge any of the terms of said lease. If the Assignee should incur any such liability, loss or damage under said lease or under or by reason of this Assignment or in defense against any such claims or demands, the amount thereof including costs, expenses and reasonable attorneys' fees, together with interest thereon at ten per cent (10%) per annum, shall be secured hereby, and the Assignor shall reimburse the Assignee therefor immediately upon demand.

6. This Assignment shall inure to the benefit of the successors and assigns of the Assignee and bind and inure to the benefit of the successors and assigns of the Assignor.

In Witness Whereof, the Assignor has caused this Assignment to be duly executed, all as of the day and year first above written.

Frank Lyon Company
By _____
President

_____
Attest:

Secretary

(Acknowledgment Omitted in Printing)

P. Ex. 29

Consent and Agreement

This Consent and Agreemen' is made by Worthen Bank & Trust Company (hereinafter called the "Bank") in order to comply with the condition set forth in paragraph 4I of an agreement (hereinafter called the "Note Purchase Agreement") dated as of May 1, 1968, between Frank Lyon Company (hereinafter called the "Company") and New York Life Insurance Company (hereinafter called the "Purchaser"), and in consideration of, and as an inducement to, the purchase by the Purchaser of the 6¾% 25-year Secured Note (hereinafter called the "Note") of the Company as provided in the Note Purchase Agreement:

1. The Bank represents and warrants to the Purchaser on and as of the closing date (as defined in paragraph 3 of the Note Purchase Agreement):

(a) The Bank is a banking corporation duly incorporated and validly existing under the laws of the State of Arkansas and is in good standing in said State.

(b) The Bank has heretofore delivered to the Purchaser copies of comparative statements of the resources and liabilities of the Bank for the fiscal years ending December 31, 1962, through December 31, 1968. Such financial statements are complete and correct and have been prepared in accordance with sound accounting principles consistently followed throughout the periods indicated. Such comparative statements accurately represent the financial condition of the Bank as at the respective dates indicated. Since December 31, 1968, there has been no material adverse change in the resources, liabilities, condition (financial or other) or business of the Bank from that set forth in the financial statement as at that date.

(c) There are no material actions, suits or proceedings pending or to the knowledge of the Bank threatened against or affecting the Bank or its property, at law or in equity or before or by any Federal, State, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, (except actions, suits or proceedings of the character normally incident to the kind of business conducted by the Bank which, if adversely determined, would not materially impair the Bank's right to carry on its business substantially as now conducted or proposed to be conducted); and the Bank is not in default with respect to any material order, writ, injunction, decree or demand of any court or Federal, State, municipal or other governmental department, commission, board, bureau, agency or instrumentality.

(d) The consummation of the transactions contemplated in the Note Purchase Agreement and performance of this Consent and Agreement and (as defined in paragraph 1 of the Note Purchase Agreement) the Deed of Trust, the Assignment, the Ground Lease, and the Building Lease will not result in any breach of, or constitute a default under, any indenture, mortgage, deed of trust, bank loan or credit agreement, corporate charter, by-law or other agreement or instrument to which the Bank is a party or by which the Bank or its properties may be bound or affected.

(e) Since December 31, 1966, neither the business nor properties of the Bank have been materially affected in any way as a result of any fire, explosion, accident, flood, windstorm, earthquake, strike, lockout, embargo, or act of God or the public enemy.

(f) The Bank is duly authorized to enter into the Building Lease and to conduct its business in the Building (as defined in paragraph 1 of the Note Purchase Agreement) and to sublease any part of the Building not required for its banking business.

(g) The Bank is not a "national" of "any designated foreign country" (or a person defined as a "designated foreign country") within the definitions in the Foreign Assets Control Regulations or the Cuban Assets Control Regulations of the United States Treasury Department, 31 C.F.R., Subtitle B, Chapter V, as amended, or any regulation or ruling issued thereunder.

(h) The Bank is not a party to or bound by any contract made otherwise than in the ordinary course of business and which in the opinion of the Bank is a burdensome contract materially and adversely affecting the business, operations or financial condition of the Bank.

(i) The Bank has not, either directly or through any agent, offered the Note or any similar security for sale to, or solicited any offer to buy the Note from, or otherwise approached or negotiated in respect thereof with, any person or persons other than the Purchaser, and the Bank agrees that neither it nor any agent on its behalf will sell or offer the Note to, or solicit any offer to buy the Note from, or otherwise approach or negotiate in respect thereof with, any person or persons whomsoever so as thereby to render the issuance and/or sale of the Note a violation of Section 5 of the Securities Act of 1933, as amended.

(j) All representations and warranties made by the Bank herein and in any certificates delivered pursuant hereto shall survive the execution of the Deed of Trust by the Bank and the sale and delivery of the Note by the Company to the Purchaser provided for in the Note Purchase Agreement, and shall be deemed to have relied on by the Purchaser notwithstanding any inquiry or investigation which the Purchaser may make in respect to the truth or accuracy of representations and warranties.

2. Supplementing paragraph 4 of the Note Purchase Agreement, the obligation of the Purchaser to purchase and pay for the Note shall be subject to the following additional conditions, all of which the Bank agrees to perform on or prior to the closing date:

(a) The Bank shall have delivered to the Purchaser copies of comparative statements of the resources and liabilities of the Bank for the fiscal years ending December 31, 1967, and December 31, 1968. Said comparative statements shall be correct and complete and truly represent the financial condition of the Bank as at the respective dates indicated and the results of the operations of the Bank for the respective periods indicated, and shall have been prepared in accordance with sound accounting practice consistently maintained throughout the periods indicated. Such comparative statements shall show no material adverse changes in the financial condition of the Bank from that set forth in the financial statement of the Bank as at December 31, 1966, heretofore delivered to the Purchaser and no material adverse changes affecting the operations of the Bank.

(b) The Bank shall have received, in form, scope and substance satisfactory to the Purchaser, the formal approval of the Board of Governors of the Federal Reserve System to the consummation of the transactions contemplated by that certain agreement (hereinafter called the "Sales Agreement") dated as of May 1, 1968, between the Company and the Bank, and of the financing and leasing transactions contemplated by the Note Purchase Agreement, to the extent that such approval is required, or proof satisfactory to the Purchaser that no such approval is required; and a copy of such approval, certified as a true copy by the President or a Vice President of the Bank, or such proof that no such approval is required, shall have been furnished to the Purchaser.

(c) The Bank shall have received, in form, scope and substance satisfactory to the Purchaser, the formal approval of the Arkansas Bank Commissioner to the consummation of the transactions contemplated by the Sales Agreement and of the financing and leasing transactions contemplated by the Note Purchase Agreement to the extent that such approval is required, or a written ruling of said Commissioner that no such approval is required; and a copy of such approval or of such ruling, certified as a true copy by the President or a Vice President of the Bank, shall have been furnished to the Purchaser.

(d) The Bank shall have a good and clear record and marketable title in fee simple absolute to Tracts A and B (as described in the Deed of Trust) and the Garage Facility (as defined in paragraph 1 of the Note Purchase Agreement) free and clear of all liens, charges and encumbrances prior to or on a parity with the lien of the Deed of Trust, except:

(i) the matters set forth Schedules I and II of the Deed of Trust;

(ii) Permitted Encumbrances, as defined in Section 1.1(10) of the Deed of Trust; and

(iii) the Building Lease.

(e) The construction of the Garage Facility shall have been completed and Cotham, Wyman & Howland, Certified Public Accountants, shall have certified to the Purchaser the Total Cost of the Mortgaged Property (as hereinbelow defined) in reasonable detail and the amount thereof shall not be less than $9,500,000. For all purposes of this Consent and Agreement. the "Total Cost of the Mortgaged Property" shall mean the sum of

(i) the Total Cost of the Building, as certified to the Purchaser by Cotham, Wyman & Howland as pro-

vided in paragraph 4D of the Note Purchase Agreement; plus

(ii) the aggregate of the costs reasonably and necessarily incurred and paid by the Bank in connection with the acquisition of Tracts A and B and charged and properly chargeable to the property accounts of the Bank in accordance with generally accepted accounting principles; plus

(iii) the aggregate of the costs reasonably and necessarily incurred and paid by the Bank in connection with said construction of the Garage Facility and charged and properly chargeable to the property accounts of the Bank in accordance with generally accepted accounting principles.

Compliance with the provisions of this Subsection (e) shall be established by such certificates of architects, engineers and contractors and officers of the Bank as shall be satisfactory in form and substance to the Purchaser. Before accepting any certificates as evidence of compliance with the provisions of this Subsection, the Purchaser in its discretion may make any further inquiry or investigation into the truth or accuracy of the matters evidenced by any certificate furnished to the Purchaser as it may deem proper. If the Purchaser shall determine to make any such further inquiry or investigation, it shall be entitled to examine the books and records of the Bank, personally or by agent or attorney, and unless satisfied with or without such examination of the truth or accuracy of the statements contained in such certificates, it shall be under no obligation to accept such certificates as evidence of such compliance.

(f) The Ground Lease, the Building Lease and the Deed of Trust shall have been duly executed and delivered by the Bank substantially in the forms of Exhibits D, E and B, respectively, to the Note Purchase Agreement, subject, however, to such changes as shall be mutually agreed upon by the Company, the Bank and the Purchaser and their respective counsel.

(g) The Purchaser shall have received from Messrs. Wright, Lindsey & Jennings, counsel for the Bank, an opinion in scope and substance satisfactory to the Purchaser and its special counsel as to all matters specified in paragraph 4N of the Note Purchase Agreement, except N(1), N(3), and N(6).

3. So long as the Purchaser shall hold the Note, the Bank will furnish to the Purchaser as soon as available, and in any event within 120 days after the end of each fiscal year, beginning with the fiscal year ending December 31, 1969, two copies of its balance sheet as of the end of such fiscal year, setting forth in comparative form the corresponding figures as at the end of the previous fiscal year, and two copies of its income and surplus statement for such fiscal year, setting forth in comparative form the corresponding figures as at the end of the previous fiscal year. Such balance sheets and statements shall be prepared in reasonable detail in accordance with good accounting practice, and shall be accompanied by a report and opinion of the auditor of the Bank or of independent public accountants. Such reports and opinions shall include a statement that such auditor or such accountants, as the case may be, in making the audit necessary for such report, have obtained no knowledge of any Event of Default, as defined in Section 17.1 of the Deed of Trust, or of any event which, with the lapse of time or with the notice and lapse of time specified in said Section 17.1 would become an Event of Default thereunder, or if such auditor or accountants shall have obtained knowledge of any such Event of Default or other event, they shall disclose in such statement the Event of Default or other events and the nature thereof. Such report of such auditor or accountants shall also include such other reports, schedules or information as

may be furnished to the Bank by such auditor or accountants in connection with such audit.

It is understood that the Purchaser shall be free to deliver copies of the financial statements referred to in this Consent and Agreement, as well as any other information or reports furnished to the Purchaser pursuant hereto, to any regulatory body or commission to whose jurisdiction the Purchaser may be subject.

4. So long as the Purchaser shall hold the Note, it shall have the right to visit and inspect any of the properties of the Bank subject to the lien of the Deed of Trust, to examine the books of account of the Bank and to discuss the affairs, finances and accounts of the Bank with, and to be advised as to the same by, the officers of the Bank, all at such reasonable times and intervals as the Purchaser may desire.

5. The Bank acknowledges notice of, and receipt of an original counterpart of, the Assignment and hereby consents to the Assignment, and agrees that payment of all Basic Rent due and to become due under the Building Lease will be made directly to the Purchaser so long the the Assignment shall continue in force, and, during the period aforesaid, the Bank will not seek or assert any reduction or abatement of any of its obligations under the Building Lease, whether by set-off, counterclaim, recoupment or otherwise.

So long as the Note is outstanding, the Bank will not, without the written consent of the holder thereof, terminate, modify or surrender or offer or permit any termination, modification or surrender of the Building Lease except upon the conditions and to the extent provided in Article XX of the Building Lease.

6. All communications provided for herein shall be delivered or mailed addressed as follows (or at such other

address as may have been furnished in writing to the Purchaser or the Bank):

To the Bank:

Worthen Bank & Trust Company
Capitol and Center Streets
Little Rock, Arkansas 72201

To the Purchaser:

New York Life Insurance Company
Attention: Vice President in Charge
of Real Estate and Mortgage
Loans
51 Madison Avenue
New York, New York 10010

7. All covenants and provisions of this Consent and Agreement shall bind and inure to the benefit of the Bank and the Purchaser and their respective successors or assigns.

IN WITNESS WHEREOF, the Bank has caused this Consent and Agreement to be duly executed this 1st day of December, 1969.

WORTHEN BANK & TRUST COMPANY

By _____
President

Attest:

_____
Secretary

P. Ex. 32

FRANK L N COMPANY
DEPT OF , CE BOX 4408
LITTLE ROCK ARKANSAS 72204

00104483
3369

399

PLEASE NOTIFY US OF ANY CHANGE IN YOUR ADDRESS

DEBITS	CREDITS	DATE	BALANCE
BALANCE BROUGHT FORWARD —		9 02 69	641,100.00
697,000.00		9 05	100.00
160,000.00	160,000.00	9 24	160,100.00
		9 25	100.00

NO OF DEBITS 2 NO OF CREDITS 1 DATE RENDERED 9 30 69 27

PLEASE INFORM US IMMEDIATELY OF ANY DISCREPANCIES YOU FIND GIVING FULL DETAILS AND YOUR ACCOUNT NUMBER

LAST AMOUNT ABOVE IS YOUR FINAL BALANCE ON DATE RENDERED

KEY TO SYMBOLS
A—CHARGE MEMO
B—CREDIT MEMO (REFER TO ADVICE)
C—CERTIFIED CHECK (ENCLOSED OR OUTSTANDING)
D—AUTHORIZED DEBIT
E—AUTHORIZED CREDIT
L—LIST
M—MAIL DEPOSIT
N—INDIRECT DRAWING
R—RETURNED ITEM
S—SERVICE AND OR MAINTENANCE CHARGE
E.O.M. BAL.—END OF MONTH BALANCE

No 13 August 29 19 69

Pay to the order of Frank Lyon Company $ 697,000.00

Six Hundred Ninety Seven Thousand Dollars and no/100 --- Dollars

FIRST NATIONAL CITY BANK
399 Park Avenue
New York N.Y.

Trf. of Funds

FRANK LYON COMPANY

:021000068: 00104483 0006700000

No 14 September 19 19 69

Pay to the order of Frank Lyon Company $ 160,000.00

One Hundred Sixty Thousand Dollars and no/100 ---------- Dollars

FIRST NATIONAL CITY BANK
399 Park Avenue
New York N Y

Transfer of Funds

Ralph Cotham

:021000068: 00104483 0016000000

CREDIT TICKET

FIRST NATIONAL CITY BANK
MORTGAGE AND REAL ESTATE LOAN DEPT.
399 PARK AVENUE, NEW YORK, N. Y. 0022

LOAN MADE 2

DATE September 24, 19

ACCOUNT NUMBER	DESCRIPTION				AMOUNT
36 56658 601	Advance Frank Lyon Company	D	8 1/2	160,000.00	160,000.00

CREDIT
Frank Lyon Company
65th & Scott Hamilton Drive
Little Rock, Arkansas, 72206
Att: Mr. Ralph Cotham, Treasurer

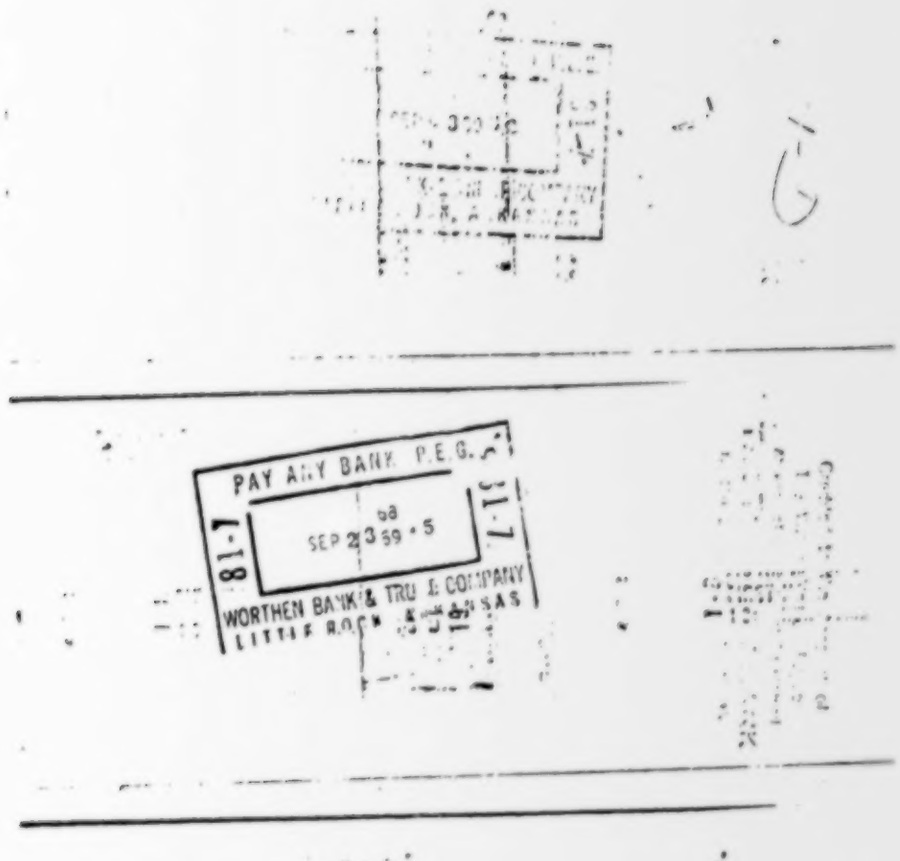
0010-4483

XX

POST
MORTGAGE AND REAL ESTATE LOAN DEPT.

:00104483 27:00160000000

BEST COPY AVAILABLE



P. Ex. 33

Frank Lyon Company and Subsidiaries

Consolidated Balance Sheet
December 31, 1969 and 1968

Assets

	1969	1968
Current Assets		
Cash	$ 1,035,661	$ 1,054,700
Short-term investments	846,859	747,830
Receivables, net	2,902,121	2,983,109
Inventories	2,573,417	2,322,879
Prepaid expenses	134,840	11,327
Total current assets	$ 7,492,898	$ 7,119,845
Investments		
Cash surrender value of life insurance	$ 0	$ 60,114
Stock in unconsolidated subsidiaries	6,110,610	2,280,278
Worthen Building	7,612,570	2,674,290
Total investments	$13,723,180	$ 5,014,682
Fixed Assets		
Property and equipment, at cost	$ 209,517	$ 180,433
Accumulated depreciation	(111,481)	(103,330)
Net fixed assets	$ 98,036	$ 77,103
Other Assets		
Receivables, due after one year	$ 9,126	$ 12,612
Deposits and memberships	1,420	1,320
Organization expense	0	50
Total other assets	$ 10,546	$ 13,982
Total Assets	$21,324,660	$12,225,612

See accompanying note to financial statements.

Frank Lyon Company and Subsidiaries

Consolidated Balance Sheet
December 31, 1969 and 1968

Liabilities and Stockholders' Equity

	1969	1968
Current Liabilities		
Accounts payable	$ 2,831,552	$ 1,892,137
Notes payable within one year	1,069,527	97,500
Accrued expenses	561,639	432,593
Taxes payable	41,280	309,272
Total current liabilities	$ 4,503,998	$ 2,731,502
Long-Term Debt		
Notes payable after one year	$11,941,986	$ 5,675,439
Deferred Liabilities		
Federal Income tax	$ 228,411	$ 0
Advertising and promotion funds	21,232	0
Reserve for losses on repurchase agreements	37,144	0
Total deferred liabilities	$ 286,787	$ 0
Stockholders' Equity		
Common stock, without par value, authorized 7,000 shares, issued 5,374 at $100 stated value per share	$ 537,400	$ 537,400
Paid in capital	58,086	58,086
Retained earnings (Exhibit C)	4,061,130	3,295,560
Treasury stock, at cost, 153 shares at 12-31-69 and 171 shares at 12-31-68	(64,727)	(72,375)
Total stockholders' equity	$ 4,591,889	$ 3,818,671
Total Liabilities and Stockholders' Equity	$21,324,660	$12,225,612

P. Ex. 34

Frank Lyon Company and Subsidiaries

Consolidated Statement of Income
Years ended December 31, 1969 and 1968

	1969		1968	
	Amount	% of Sales	Amount	% of Sales
Sales	$18,862,859	100.0	$19,154,673	100.0
Cost of sales	15,861,134	84.1	16,016,414	83.6
Gross profit	$ 3,001,725	15.9	$ 3,138,259	16.4
Operating expenses (Schedule 1)	2,035,870	10.8	1,956,138	10.2
Operating profit	$ 965,855	5.1	$ 1,182,121	6.2
Other Income and Expenses				
Discounts earned	$ 21,039	.1	$ 19,957	.1
Bad debts recovered	6,387	.0	13,777	.0
Interest income	83,524	.4	107,841	.6
Interest expense	(45,284)	(.2)	(171,416)	(.9)
Contributions	(41,536)	(.2)	(45,341)	(.2)
Miscellaneous	64,506	.4	39,856	.2
Net other income and expenses	$ 88,636	.5	$ (35,326)	(.2)
Operating income before taxes	$ 1,054,491	5.6	$ 1,146,795	6.0
Income Taxes				
State	$ 8,152	.0	$ 40,517	.2
Federal	496,010	2.7	547,785	2.9
Total income taxes	$ 504,162	2.7	$ 588,302	3.1
Net Operating Income	$ 550,329	2.9	$ 558,493	2.9
Net Income from Investments	260,031	1.4	0	.0
Net income (to Exhibit C)	$ 810,360	4.3	$ 558,493	2.9
Net income per share	$ 155		$ 108	

See accompanying notes to financial statements

FRANK LYON COMPANY AND SUBSIDIARIES

Consolidated Statement of Operating Expense
Years ended December 31, 1969 and 1968

	1969		1968	
	Amount	% of Sales	Amount	% of Sales
Salaries and wages	$ 596,662	3.3	$ 548,620	3.0
Salesmen's earnings	449,296	2.5	423,455	2.2
Bonuses accrued	200,969	1.2	221,874	1.2
Overtime pay	7,722	.0	6,662	.0
Payroll taxes	35,891	.2	34,549	.2
Employee insurance	13,717	.1	9,773	.1
Pension plan	96,010	.5	73,000	.4
Audit, legal and collection	23,241	.1	11,536	.1
Automobile expenses	7,172	.0	8,958	.0
Bad debts	(13,149)	(.1)	19,715	.1
Bank charges	515	.0	635	.0
Data processing expense	108,625	.6	98,817	.5
Depreciation	18,060	.1	15,914	.0
Directors' fees	7,200	.0	6,000	.0
Dues and subscriptions	11,598	.1	12,295	.1
Employees' education expense	1,149	.0	781	.0
Entertainment	4,214	.0	476	.0
Freight	24,263	.1	34,932	.2
Insurance, general	19,530	.1	16,363	.1
Insurance, officers' life	5,812	.0	4,481	.0
Maintenance	17,753	.1	16,703	.1
Merchandise repairs	3,978	.0	2,414	.0
Miscellaneous	9,578	.1	5,752	.0
New employee expense	2,218	.0	1,590	.0
Overhead recovery	(33,599)	(.2)	(13,128)	(.1)
Outside labor	3,504	.0	3,228	.0
Postage	14,674	.1	15,969	.1
Rent, buildings	209,413	1.1	188,122	1.0
Rent, equipment	210	.0	233	.0
Service, net	2,868	.0	6,245	.0
Supplies	25,885	.1	26,244	.1
Telephone and telegraph	45,156	.2	45,415	.2
Taxes and licenses	61,386	.3	59,526	.3
Travel	28,823	.1	27,544	.2
Truck expense	3,231	.0	2,014	.0
Utilities	22,355	.1	19,431	.1
Totals (to Exhibit B)	$2,035,870	10.8	$1,956,138	10.2

P. Ex. 35

GUARANTY

May 14, 1968

First National City Bank
399 Park Avenue
New York, New York 10022

Gentlemen:

Reference is made to the Building Loan Agreement (the "Loan Agreement") dated May —, 1968, between you and Frank Lyon Company (the "Borrower"), with respect to a proposed construction loan (the "Construction Loan") in the amount of Seven Million Dollars ($7,000,000.00), to be made by you to the Borrower in connection with the construction of a 24-story bank and office building (the "Worthen Building"), on a parcel of land located at Center and Capitol Streets, Little Rock, Arkansas (the "Premises").

The undersigned (the "Guarantor) acknowledges that you are relying upon the Note Purchase Agreement of New York Life Insurance Company with the Borrower dated as of May 1, 1968 (the "Note Purchase Agreement"), to make a permanent loan (the "Permanent Loan") on the Worthen Building and a certain parking facility, also to be constructed on the Premises (the "Parking Facility"), in compliance with the terms and conditions of the Note Purchase Agreement.

In order to induce you to enter into the Loan Agreement and to make the Construction Loan thereunder to the Borrower, and in consideration thereof, the undersigned hereby irrevocably guarantees to you and your successors and assigns, that construction of the Worthen Building and of Parking Facility will be fully completed by December 1st, 1969, in accordance with the plans and specifications referred to in the Loan Agreement and in

compliance with all of the provisions of the Loan Agreement and the Note Purchase Agreement, free from all liens and claims which may be filed or made for performing work and labor thereon or furnishing materials therefor, or both, and further guarantees the full compliance of all terms, conditions and agreements of the Loan Agreement on its part to be observed.

The Guarantor further agrees that if for any reason whatsoever the Construction Loan is not paid off in full by December 1st, 1969, a new Building Lease of the Worthen Building will be entered into between the Borrower, as lessor, and the Guarantor herein, as lessee, on terms and conditions to be agreed upon by you, which will provide sufficient rentals to amortize fully the principal and interest of a permanent loan, in accordance with its terms, which Guarantor hereby agrees are to be acceptable to you.

The Guarantor further guarantees to occupy at least 110,000 square feet of interior space in the building and that such space will be finished for occupancy by December 1, 1969.

Guarantor further guarantees that prior to the first advance of funds hereunder, the Lender is to be supplied with opinions of Guarantor's attorneys, satisfactory to Lender, as to the following matters:

(a) An opinion asserting Guarantor's power to mortgage its property to secure another's debt.

(b) An opinion to the effect that Lender's making of the Loan will not constitute "doing business" in Arkansas or violate any other local statute.

(c) An opinion stating that Guarantor has the power to guaranty completion of the building and that such guaranty will not constitute indebtedness or liability of Guarantor under any applicable statute limiting the indebtedness or liability which may be legally incurred or assumed by Guarantor, or that if it does constitute such indebtedness or liability, it will not cause Guarantor to exceed the statutory limits.

(d) An opinion to the effect that the entire transaction will not result in Guarantor's violating any statutory limitation on investment in bank premises or other real property.

Any changes or alterations which may be made in the terms of the Loan Agreement or the giving of any extension of time for the performance of the Loan Agreement or any other forbearance on your part to the Borrower, shall not in any way release the Guarantor herein of the obligations under this guaranty, notice to the Guarantor of any such change, alteration, extension or forbearance being hereby waived.

The Guarantor hereby waives notice of the acceptance hereof and this guaranty shall be binding upon the undersigned, its successors and assigns, and the undersigned represents that it has full legal power under its Certificate of Incorporation and under the laws and statutes of the State of Arkansas to execute this guaranty.

This guaranty may not be modified, discharged or terminated in any manner other than by agreement in writing signed by you and the Guarantor herein.

Very truly yours,

WORTHEN BANK & TRUST COMPANY

By /s/ EDWARD M. PENICK
Edward M. Penick
President

P. Ex. 36

FRANK LYON COMPANY

COMPUTATION OF TAX LOSS ON WORTHEN BUILDING

	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	Total
Rental Income	48,527.01	582,324.12	582,324.12	582,324.12	582,324.12	582,324.12	582,324.12	582,324.12	582,324.12	582,324.12	582,324.12	584,893.55	
Other Deductions	451,666.75												
Interest Expense	40,162.50	478,801.52	471,634.87	463,971.97	455,778.93	447,018.36	437,651.43	427,636.04	416,927.31	405,477.24	393,234.49	380,144.22	
Depreciation—DDB	51,618.79	614,269.78	552,942.51	498,536.65	450,186.74	407,160.58	368,818.99	334,603.45	304,025.71	276,658.68	252,128.58	230,107.80	
Total Deductions	543,448.04	1,093,071.30	1,024,577.38	962,508.62	905,965.67	854,178.94	806,470.42	762,239.49	720,953.02	682,135.92	645,363.07	610,252.02	
Net Loss for Tax Purposes	494,921.03	510,747.18	442,253.26	380,184.50	323,641.55	271,854.82	224,146.30	179,915.37	138,628.90	99,811.80	63,038.95	25,358.47	
48% Tax or (Tax Credit)	(237,562.09)	(245,158.65)	(212,281.56)	(182,488.56)	(155,347.94)	(130,490.31)	(107,590.22)	(86,359.37)	(66,541.87)	(47,909.66)	(30,258.70)	(12,172.06)	
Depreciation—DDB	51,618.79	614,269.78	552,942.51	498,536.65	450,186.74	407,160.58	368,818.99	334,603.45	304,025.71	276,658.68	252,128.58	210,932.17	4,321,882.63
Depreciation—SL	25,808.10	309,697.34	309,697.34	309,697.34	309,697.34	309,697.34	309,697.34	309,697.34	309,697.34	309,697.34	309,697.34	283,889.10	3,406,670.60
Excess Depreciation	25,810.69	304,572.44	243,245.17	188,839.31	140,489.40	97,463.24	59,121.65	24,906.11	(5,671.63)	(33,038.66)	(57,568.76)	(72,956.93)	915,212.03

595

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Rental Income	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28	613,157.28
Interest Expense	365,180.57	348,013.67	329,658.33	310,032.29	289,047.59	266,610.15	242,619.43	216,967.87	189,540.51	160,214.42	128,858.14	95,331.11	59,483.10
Depreciation—DDB	142,363.75	135,245.56	128,483.28	122,059.12	115,956.12	110,158.35	104,650.44	99,417.92	94,447.02	89,724.67	85,238.44	80,976.51	76,927.69
Total Deductions	507,544.32	488,413.87	458,141.61	432,091.41	405,003.75	376,768.50	347,269.87	316,385.79	283,987.53	249,939.09	214,096.58	176,307.62	136,410.79
Net (Loss) or Gain	105,612.96	124,743.41	155,015.67	181,065.87	208,153.53	236,388.78	265,887.41	296,771.49	329,169.75	363,218.19	399,060.70	436,849.66	476,746.49
×48% = Income Tax	50,694.62	59,876.84	74,407.52	86,911.62	99,913.00	113,466.61	127,625.96	142,450.31	158,001.48	174,344.73	191,549.14	209,687.84	228,838.31

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Rental Income	587,060.84	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00
Interest Expense	21,201.61												
Ground Rent	8,333.33	100,000.00	100,000.00	100,000.00	100,000.00	104,166.37	150,000.00	150,000.00	150,000.00	150,000.00	154,166.67	200,000.00	200,000.00
Depreciation—DDB	73,081.30	69,427.24	65,955.88	62,658.08	59,525.18	56,548.92	53,721.47	51,035.40	48,483.63	46,059.45	43,756.48	41,568.65	39,490.22
Total Deductions	102,616.24	169,427.24	165,955.88	162,658.08	159,525.18	160,715.59	203,721.47	201,035.40	198,483.63	196,059.45	197,923.15	241,568.65	239,490.22
Net Gain or (Loss)	484,444.60	130,572.76	134,044.12	137,341.92	140,474.82	139,284.41	96,278.53	98,964.60	101,516.37	103,940.55	102,076.85	58,431.35	60,509.78
×48% = Income Tax	232,533.41	62,674.92	64,341.18	65,924.12	67,427.91	66,856.52	46,213.69	47,503.01	48,727.86	49,891.46	48,996.89	28,047.05	29,044.69

P. Ex. 36

FRANK LYON COMPANY

COMPUTATION OF TAX LOSS ON WORTHEN BUILDING

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Rental Income	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00
Ground Rent	200,000.00	200,000.00	204,166.66	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00
Depreciation—DDB	37,515.71	35,639.92	33,857.93	32,165.03	30,556.78	29,028.94	27,577.49	26,198.62	24,888.68	23,644.25	22,462.04	21,338.94	20,271.99
Total Deductions	237,515.71	235,639.992	238,024.59	282,165.03	280,556.78	279,028.94	277,577.49	276,198.62	274,888.68	273,644.25	272,462.04	271,338.94	270,271.99
Net Gain or (Loss)	62,484.29	64,360.08	61,975.41	17,834.97	19,443.22	20,971.06	22,422.51	23,801.38	25,111.32	26,355.75	27,537.96	28,661.06	29,728.01
×48% — Income Tax	29,992.46	30,892.84	29,748.20	8,560.78	9,332.75	10,066.11	10,762.80	11,424.66	12,053.43	12,650.76	13,218.22	13,757.31	14,269.44

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Rental Income	300,000.00	300,000.00	300,000.00	300,000.00	300 000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00
Ground Rent	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00
Depreciation—DDB	19,258.39	18,295.47	17,380.70	16,511.66	15,686.08	14,901.78	14,156.69	13,448.85	12,776.41	12,137.59	11,530.71	10,954.18	10,406.47
Total Deductions	269,258.39	268,295.47	267,380.70	266,511.66	265,686.08	264,901.78	264,156.69	263,448.85	262,776.41	262,137.59	261,530.71	206,954.18	260,406.47
Net Gain or (Loss)	30,741.61	31,704.53	32,619.30	33,488.34	34,313.92	35,098.22	35,843.31	36,551.15	37,223.59	37,862.41	38,469.29	39,045.82	39,593.53
×48% = Income Tax	14,755.97	15,218.17	15,657.26	16,074.40	16,470.68	16,847.14	17,204.79	17,544.55	17,867.32	18,173.96	18,465.26	18,741.99	19,004.89

	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042	2043	2044 11 months
Rental Income	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	300,000.00	275,000.00
Ground Rent	250,000.00	230,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	9,166.67
Depreciation—DDB	9,886.14	9,391.84	8,922.24	8,476.13	8,052.33	7,649.71	7,267.22	6,903.86	6,558.67	6,230.74	5,919.20	5,154.64
	259,886.14	239,391.84	18,922.24	18,476.13	18,052.33	17,649.71	17,267.22	16,903.86	16,558.67	16230.74	15,919.20	14,321.31
Net Gain or (Loss)	40,113.86	60,608.16	281,077.76	281,523.87	281,947.67	282,350.29	282,732.78	283,096.14	283,441.33	283,769.26	284,080.80	260,678.69
×48% = Income Tax	19,254.65	29,091.91	134,917.32	135,131.46	135,334.88	135,528.14	135,711.73	135,886.15	136,051.84	136,209.24	136,358.78	125,125.77

596

P. Ex. 37

FEDERAL RESERVE BANK OF ST. LOUIS
P.O. BOX 442
ST. LOUIS, MISSOURI 63166

O. O. WYRICK
VICE PRESIDENT

August 22, 1967

Mr. Edward M. Penick, President
Worthen Bank and Trust Company
P. O. Box 1681
Little Rock, Arkansas 72203

Dear Mr. Penick:

This will acknowledge your letter of August 18, 1967, together with a copy of letter to Mr. H. C. Adams, State Bank Commissioner, requesting approval for the purchase of land for location of a new bank building.

Since the bid of $1,425,299.95 for the land plus the present carrying value of bank premises does not exceed the amount of the bank's capital stock, the approval of the Board of Governors of the Federal Reserve System, under the provisions of Section 24A of the Federal Reserve Act is not required and this Reserve bank will interpose no objection to the proposal. However, if the total investment in the new bank building, including cost of land, plus amount of bank premises now carried on the bank's books will exceed the bank's capital stock ($4,000,000) the investment will require the prior approval of the Board of Governors. Any investment in a real estate holding company holding title to the premises carried on the bank's books plus all indebtedness incurred by the company shall be included in determining the total investment for the purpose of Section 24A.

In the event the bank's investment in connection with the new building program requires the prior approval of

the Board of Governors, a request for such approval should be forwarded to this office outlining in some detail the proposed expenditures for bank premises and furniture and fixtures together with information regarding financing arrangements and proposed depreciation of fixed assets.

If you have any questions, please let me know.

Very truly yours,

/s/ O. O. Wyrick
O. O. Wyrick
Vice President

P. E[redacted]

Summary of Conversation With Mr. O. O. Wyrick
9/6/67

Mr. Wyrick called me today and said he had received my letter that I'd written to Mr. Adams and had a chance to go over it in detail. There were a few things he wanted to clear up.

He said if this was going to be a clear sale, in other words Goldman, Sachs or the investors were going to build the building and then lease it to us, that he would have no hesitancy in approving it right away. However, if we were going to build the building and were going to borrow the 7½ million dollars in interim financing funds and then sell the building to Goldman, Sachs and lease it back that he could not approve this without going to the Board of Governors of the Federal Reserve if at any time the 7½ million would appear on our balance sheet as a liability.

We had discussed this possibility with the representatives of Goldman, Sachs by going one of two ways. Either we would handle the interim financing and sell the building to them after completion, or let them handle the interim financing with us selling the land to them from the start. After my discussion with Mr. Wyrick we again discussed this point with Goldman, Sachs representatives Ross and Fuchs. We told them that it would be much simpler if we sold the land to them, let them build the building, and arranged for immediate take-down of the money (probably starting in January of next year). In this way we could go ahead without any hitch, otherwise, we may be looking at a 60 to 90 day delay in getting the approval of the Federal Reserve Board in Washington. They said this was no problem and we would probably have to put our money into it from now til the end of the year and keep records

of it, then when they got the take-down in 1968 that we could take it down for what we had in it.

I am to let Mr. Wyrick know as soon as possible what we have resolved on this and he then will give us his final approval of it. The big problem in this matter of financing, however, is how do we go about saving the $125,000 in sales tax that we don't want to pay. I have handed this problem to Mr. Darr and asked him to follow up with Mr. Meek in outlining a procedure where we could buy the materials in the bank's name and then put it into the building and be repaid or have the permanent owners pay the suppliers

P. Ex. 39

EASTMAN DILLON, UNION SECURITIES & Co.
ONE CHASE MANHATTAN PLAZA
NEW YORK, NEW YORK, 10005

September 20, 1967

Mr. E. M. Penick, President
Worthen Bank & Trust Company
Little Rock, Arkansas

Re: Sale-Leaseback Financing
of New Bank Headquarters

Dear Mr. Penick:

In accordance with our discussions on September 13, we are setting forth herein our understanding of your requirements to finance the new Bank headquarters facilities. Based on these requirements, Stephens, Inc. and we are submitting to you herewith our recommendation of a program which may best fulfill your objectives.

Over the course of the last several years, Eastman Dillon, Union Securities & Co. has completed over $250 million of leaseback financing for bank facilities. The financing we presently contemplate for your Bank is comparable to these transactions. Aside from certain considerations peculiar to the various financings, the principal difference in your transaction is that ownership of your properties will rest with a totally independent landlord rather than with a corporation affiliated with your Bank. We have also arranged financings of this type aggregating in the hundreds of millions for major industrial corporations.

As a result of our substantial backlog of experience, we believe we can provide you with a maximum flexibility for the day-by-day use of the properties as well as favorable opportunities to purchase the properties at a reasonable price or continue as a tenant for a protracted period of

time. Furthermore, we can assure you of professional preparation and execution of all the technical details involved in such a complex transaction.

The Financing Requirements of the Bank

Land Value	$1,430,000
Cost of Financing:	
Headquarters Building	$7,000,000
Parking Deck	700,000
Total Financing	$7,700,000
Ground Breaking—	September 15, 1967
Estimated Completion Date of Construction—	June 30, 1969

Construction Financing Required

We understand that the Federal Reserve has determined that your total investment in this financing program should not exceed approximately $4 million. Accordingly, it will be necessary to provide construction financing. Such construction financing can be made available under our proposal, provided the Bank guarantees that the building will be completed to its satisfaction, by arranging for the takedown of all or a portion of the funds from the subject financing in the Spring of 1968. Any balance can be made available either during the course of construction or upon completion.

Financing Proposal

Our proposal assumes that you agree with our remarks of September 13 that it would be desirable for the Bank to continue to own the ground underlying the headquarters building and parking deck. Such a program would simplify the establishment of an equitable subsequent purchase price by the Bank, would not require the establishment of a

valuation for that portion of land underlying the headquarters building, and would perhaps meet the desire of your directors in having a proprietary interest in the facilities.

Title to the headquarters building and parking deck (the "Property") will rest with a limited partnership (the "Partnership") which will include Mr. Stephens and other individuals. The Partnership will lease the property to Worthen Bank and Trust Company (the "Bank") for a basic term of 25 years. The Partnership would finance the cost of the Property by the issuance of mortgage indebtedness to a special purpose corporation, Worthen Properties, Inc. (Worthen), organized by us solely for the purpose of doing this transaction. Such indebtedness would be secured by a mortgage on the Property and by an assignment to Worthen of a Lease (the "Lease") between the Partnership and the Bank.

Worthen would, in turn, finance the cost of acquiring such mortgage indebtedness of the Partnership through the sale of its Collateral Notes (the "Notes") to institutional investors. The Notes of Worthen would be secured by an assignment for the benefit of the institutional investors of its interest in such mortgage indebtedness, such mortgage and the Lease. The Notes will have a 25-year maturity and will be repaid 100% from rentals payable under the Lease. Rentals under the Lease will be sufficient and pay interest on the Notes and provide a modest cash income to the Partnership.

You will be provided with purchase options and lease renewal options as hereinafter set forth.

Interim Term of the Lease

The interim term of the Lease will begin on the closing date and will terminate upon completion of construction.

No rent will be payable during the interim term. Interest only will be payable upon expiration of the interim term.

The Lease

Under the Lease, the Bank will be permitted to make any alterations or improvements without prior approval so long as the resultant value of the Property is not thereby reduced. In the event of partial condemnation of or casualty to the Property, the Bank will be required to restore the Property and will be entitled to the insurance proceeds or the award. In the event of major condemnation of or casualty to the Property, the Bank will be permitted to cancel the Lease upon making an offer to purchase the Property and the leasehold interest in the underlying land at a price equal to the outstanding Note balance, if any. If such offer is accepted, the Bank would be entitled to receive the proceeds of any award or insurance.

The Lease will also provide that if either Worthen, the Partnership or the Bank be required to divest its estate in the Property by any Federal or state regulatory authority, the Lease may be terminated and the Bank would be required to make an offer to purchase such Property and the leasehold interest in the underlying land at a price equal to the Note balance.

The Bank will not be permitted to cancel the Lease during its initial ten years. Beginning with the eleventh year, the Bank will be permitted to cancel the Lease if it becomes uneconomic to continue the use and occupancy of the Property by offering to purchase the Property and the leasehold interest in the underlying land at a price at least equal to the outstanding Note balance. The Bank will also be permitted to cancel the Lease beginning in the eleventh year for any other reason, upon making a similar purchase offer plus appropriate premium. Except as described herein, the Lease may not be cancelled under any circumstances and the rent payable thereunder may not be abated.

The Lease will provide that in the event any claims are asserted against any of the rents so as to interfere with

their receipt by the trustee for the Noteholders or their application by the trustee or the Noteholders to the required payments of interest and principal on the Notes, the Bank will either satisfy such claims or liens or purchase the Property and the leasehold interest in the underlying land at a price sufficient to prepay the Notes and thereby terminate the Lease. This provision is known as a "lien offset agreement" and is necessary in this type of transaction to assure the Noteholders that they will receive payment on the Notes quarterly when due and payable and, therefore, to obtain the most favorable terms and rate of interest.

Renewal Options

The Bank will be provided with eight 5-year renewal options after the expiration of the basic 25-year Lease term. Rentals payable under such renewal terms will be as follows:

Five Year Renewal Options	*Annual Lease Rentals* (a)
1st	2½%
2nd	2
3rd	1½
4th	1
5th	1
6th	1
7th	1
8th	1

(a) As a per cent of original $7,700,000 cost.

The Ground Lease

The ground lease will have a term of 80 years. The ground lease will not contain any incurable defaults and the trustee for the Noteholders will have the right to cure all defaults occurring thereunder. In addition, the ground

lease will contain other provisions customary to this type of financing for the protection of the Noteholders, and must be acceptable to counsel for the Noteholders.

The Notes

The Notes will mature on the 25th anniversary of the commencement of the basic Lease term. After the commencement of the basic Lease term, the Notes will be payable in equal quarterly payments of interest and principal, in arrears. These installments will be sufficient to amortize 100% of the principal amount of the Notes by maturity together with accrued interest thereon. The Notes will be subject to prepayment only as follows:

1. In part with any monies remaining in the escrow fund after the completion of construction, at par.

2. In whole at any time in the event the Lease is terminated due to required divestiture, substantial casualty or condemnation, at par.

3. In whole at any time in the event of the termination of the Lease by the Bank due to the exercise of its obligations under the lien-offset agreement, at par.

4. In whole at any time after the tenth year of the basic Lease term in the event of uneconomic conditions, at par.

5. In whole at any time after the tenth year of the basic Lease term, at the option of Worthen or by reason of the termination of the Lease for other reasons, at 100% of the unpaid principal amount of the Notes, plus a premium of approximately 4% during the eleventh year, which premium shall decline in equal annual steps to zero at the end of the 24th year of the basic Lease term.

Escrow Fund

The proceeds of the Notes issued at the closing in the Spring of 1968 and any subsequent closings prior to completion of construction will be deposited in an escrow account to be created under the indenture. Monies deposited in the escrow fund will be paid to Worthen by the trustee upon certification of expenditures made in construction. During the life of the escrow fund, proceeds may be invested by the trustee, at the direction of the Bank, in securities having a maturity not in excess of the estimated period of construction. The investment will be limited to obligations of the U. S. Government or its agencies, certificates of deposit of banks having assets in excess of $1 billion or certificates of deposit of the Bank. The Bank will be responsible for any losses from the investment of the escrow fund.

Additional Notes

Any future additions or improvements may be financed by Worthen through the issue of additional notes in the principal amount of at least $500,000. Repayment of such additional notes shall be made by increasing rentals payable under the Lease by an appropriate amount.

Repurchase Options

The Bank will be provided with options to repurchase the Property at the end of the 15th year, the 20th year, the 25th year and the 30th year. The price to be paid shall be determined as follows: Assuming straight line depreciation on the Property and a 40-year useful life, the purchase price will be equivalent to the depreciated book value. The following schedule compares the estimated book value, debt balance and difference between the two at the four purchase option dates:

Purchase Option Date	(Purchase Price) 40-Year Life Straight Line Depreciated Book Value	Outstanding Note Balance	Difference: Purchase Price Over Debt Balance
15th year	$4,812,500	$4,678,665	$ 133,835
20th year	3,850,000	2,741,219	1,108,781
25th year	2,887,500	—0—	2,887,500
30th year	1,925,000	—0—	1,925,000

Cost of Financing

It is our understanding that the Bank will pay the cost of counsel representing the Note purchasers, the cost of printing the necessary legal documents, the initial and annual trustee expenses, and any other expenses associated with the transfer of title recording of the appropriate documents and incidental closing costs. It will not be necessary to provide title insurance so long as the Bank will supply a full covenant and warranty deed in satisfactory form. No fee will be payable to Stephens, Inc. or Eastman Dillon, Union Securities & Co. for arranging the financing.

There are probably a number of questions left unanswered since I have attempted to describe in a few paragraphs a rather sophisticated form of financing. Please bear in mind that the above proposal can be altered in order to fully accommodate the requirements or preferences of the Bank and your Board of Directors.

We shall be happy to further discuss this transaction at your convenience either in Little Rock or New York City.

Yours very truly,

/s/ Theodore M. Siouris
Theodore M. Siouris
A General Partner

P. Ex. 40

Worthen Bank and Trust Company
Little Rock, Arkansas

April 16, 1968

Mr. H. C. Adams
State Bank Commissioner
National Old Line Building
Little Rock, Arkansas

Re: Construction of Worthen Building

Dear Mr. Adams:

I have previously discussed with you, and you have previously indicated your approval of the sale and lease back arrangement for the financing of our new bank building. However, attorneys for New York Life Insurance Company, the permanent lender, and First National City Bank of New York, the construction lender, have requested that Worthen Bank & Trust Company obtain formal approval by the State Bank Commission of the consummation of the transactions involved in the construction of our new bank and office building.

The purpose of this letter is to outline briefly the transactions involved in the construction of the Worthen Building.

The Bank owns Lots 1 through 8 and the South 16.45 feet of Lot 9, Block 84, Original City of Little Rock, Pulaski County, Arkansas.

Pursuant to a construction contract with Matson-Bellows, a joint venture, the Bank is constructing on the southern portion of such land a bank and office building, hereafter referred to as the "Bank Building," and on the northern portion a garage and parking facility, hereafter referred to as the "Parking Facility."

The Bank shall sell the Bank Building, but neither the land underlying it nor the adjoining Parking Facility, to

Frank Lyon Company for the sum of $7,640,000. Title to the Bank Building shall pass to Frank Lyon Company as construction progresses.

The Bank shall deliver to Frank Lyon Company a warranty deed to the Bank Building.

Frank Lyon Company has arranged for the construction loan with First National City Bank of New York. The loan commitment of First National City Bank requires the execution of the following documents:

(a) Building Loan Agreement between Frank Lyon Company and First National City Bank setting forth the conditions of the loan.

(b) Building Loan Mortgage Note in the amount of $7,000,000 executed only by Frank Lyon Company and payable to First National City Bank.

(c) Building Loan Mortgage executed by Frank Lyon Company and the Bank to secure payment of the indebtedness of $7,000,000. covering the Bank Building, Frank Lyon Company's interest in the Ground Lease of the land underlying the Bank Building, the interest of Frank Lyon Company in the lease of the Bank Building to the Bank, and the interest of the Bank in the land underlying the Bank Building and in the adjoining Parking Facility.

(d) Guaranty whereby the Bank guarantees to First National City Bank that construction of the Bank Building will be fully completed by December 1, 1969, in accordance with the plans and specifications therefor, free of all liens; that it will comply with the terms of the loan Agreement applicable to it; that, if the construction loan is not paid off by December 1, 1969, the Bank will enter into a new lease of the Bank Building with Frank Lyon Company with sufficient rent to amortize the principal and interest of a permanent loan in accordance with terms acceptable to First National City Bank; that the Bank will occupy at least 110,000 square feet of interior space in the Bank Building; and that such space will be finished for occupancy by December 1, 1969.

Frank Lyon Company will lease the Bank Building to the Bank for a term of 25 years at a rental sufficient to amortize the permanent loan to be made by New York Life Insurance Company. The Bank has the option to extend the lease for 8 additional terms of five years each at an annual rental of $300,000 and has the option to purchase the Bank Building upon the following terms:

Date	Purchase Price
November 30, 1980	$ 800,000
November 30, 1984	$1,000,000
November 30, 1989	$1,603,568
November 30, 1994	$2,145,935

In the event of such purchase, the Bank shall assume all indebtedness against the Bank Building evidenced by the New York Life loan.

The Bank will lease the land underlying the Bank Building to Frank Lyon Company for a term expiring upon the first to occur of (a) November 30, 2044, and (b) termination of the lease of the Bank Building as provided therein. The Ground Lease rental shall be $1.00 per year until November 30, 1994, the date on which the permanent loan by New York Life Insurance Company shall by its terms have been repaid.

Frank Lyon Company will arrange for permanent financing of the Bank Building by means of the sale to New York Life Insurance Company of a promissory note made by Frank Lyon Company in the principal amount of $7,140,000. The agreement of New York Life Insurance Company to purchase the promissory note shall be in the form of a Note Purchase Agreement.

Pursuant to the commitment of New York Life Insurance Company, the promissory note of Frank Lyon Company shall be secured by a deed of trust executed by Frank Lyon Company and the Bank to a trustee designated by New York Life Insurance Company, covering the Bank Building (subject to the Bank's lease), the interest of Frank Lyon Company in the lease of the Bank Building, the interest of Frank Lyon Company in the lease of the land underlying the Bank Building, the interest of the Bank in the land underlying the Bank Building and in the adjoining Parking Facility.

As a further condition to making the permanent loan, New York Life has required that the Bank enter into a Consent and Agreement whereby the Bank makes certain representations to New York Life with respect to the Bank's corporate status, its financial affairs, its authority to enter into the various transactions contemplated, its authority to enter into the various leases, its title to the land underlying the Bank Building and the Parking Facility, cost of the Bank Building and Parking Facility, proper execution of the various instruments, and the right of New York Life to inspect the property subject to the lien of the deed of trust and to examine the books of account of the Bank.

Since your approval of the foregoing is being required by First National City Bank to close the construction loan, we would greatly appreciate hearing from you at your earliest convenience.

Sincerely,

/s/ Ed Penick
President

The plan of financing your building as outlined in this letter has my approval.

Date: 4/17/1968.

Arkansas State Bank Commissioner
By H. C. Adams
H. C. Adams

P. Ex. 41

Worthen Bank and Trust Company
LITTLE ROCK, ARKANSAS

April 16, 1968

Mr. O. O. Wyrick
Vice President
Federal Reserve Bank of St. Louis
P. O. Box 442
St. Louis, Missouri 63166

Dear Mr. Wyrick:

I have previously discussed with you, and you have previously indicated your approval of the sale and lease back arrangement for the financing of our new bank building. However, Attorneys for New York Life Insurance Company, the permanent lender, and First National City Bank of New York, the construction lender, have requested that Worthen Bank & Trust Company obtain formal approval by the Board of Governors of the Federal Reserve System of the consummation of the transactions involved in the construction of our new bank and office building.

If formal approval of the Board of Governors is not required, we must furnish proof in the form of a letter from you to that effect.

The purpose of this letter is to outline briefly the transactions involved in the construction of the Worthen Building.

The Bank owns Lots 1 through 8 and the South 16.45 feet of Lot 9, Block 84, Original City of Little Rock, Pulaski County, Arkansas.

Pursuant to a construction contract with Matson-Bellows, a joint venture, the Bank is constructing on the southern portion of such land a bank and office building.

hereafter referred to as the "Bank Building," and on the northern portion a garage and parking facility, hereafter referred to as the "Parking Facility."

The Bank shall sell the Bank Building, but neither the land underlying it nor the adjoining Parking Facility, to Frank Lyon Company for the sum of $7,640,000. Title to the Bank Building shall pass to Frank Lyon Company as construction progresses.

The Bank shall deliver to Frank Lyon Company a warranty deed to the Bank Building.

Frank Lyon Company shall arrange for the construction loan with First National City Bank of New York. The loan commitment of First National City Bank requires the execution of the following documents:

(a) Building Loan Agreement between Frank Lyon Company and First National City Bank setting forth the conditions of the loan.

(b) Building Loan Mortgage Note in the amount of $7,000,000 executed only by Frank Lyon Company and payable to First National City Bank.

(c) Building Loan Mortgage executed by Frank Lyon Company and the Bank to secure payment of the indebtedness of $7,000,000. covering the Bank Building, Frank Lyon Company's interest in the Ground Lease of the land underlying the Bank Building, the interest of Frank Lyon Company in the lease of the Bank Building to the Bank, and the interest of the Bank in the land underlying the Bank Building and in the adjoining Parking Facility.

(d) Guaranty whereby the Bank guarantees to First National City Bank that construction of the Bank Building will be fully completed by December 1, 1969, in accordance with the plans and specifications

therefor, free of all liens; that it will comply with the terms of the Loan Agreement applicable to it; that, if the construction loan is not paid off by December 1, 1969, the Bank will enter into a new lease of the Bank Building with Frank Lyon Company with sufficient rent to amortize the principal and interest of a permanent loan in accordance with terms acceptable to First National City Bank; that the Bank will occupy at least 110,000 square feet of interior space in the Bank Building; and that such space will be finished for occupancy by December 1, 1969.

Frank Lyon Company will lease the Bank Building to the Bank for a term of 25 years at a rental sufficient to amortize the permanent loan to be made by New York Life Insurance Company. The Bank has the option to extend the lease for 8 additional terms of five years each at an annual rental of $300,000 and has the option to purchase the Bank Building upon the following terms:

Date	Purchase Price
November 30, 1980	$ 800,000
November 30, 1984	$1,000,000
November 30, 1989	$1,603,568
November 30, 1994	$2,145,935

In the event of such purchase, the Bank shall assume all indebtedness against the Bank Building evidenced by the New York Life loan.

The Bank will lease the land underlying the Bank Building to Frank Lyon Company for a term expiring upon the first to occur of (a) November 30, 2044, and (b) termination of the lease of the Bank Building as provided therein. The Ground Lease rental shall be $1.00 per year until November 30, 1994, the date on which the permanent loan by New York Life Insurance Company shall by its terms have been repaid.

Frank Lyon Company will arrange for permanent financing of the Bank Building by means of the sale to New York Life Insurance Company of a promissory note made by Frank Lyon Company in the principal amount of $7,140,000. The agreement of New York Life Insurance Company to purchase the promissory note shall be in the form of a Note Purchase Agreement.

Pursuant to the commitment of New York Life Insurance Company, the promissory note of Frank Lyon Company shall be secured by a deed of trust executed by Frank Lyon Company and the Bank to a trustee designated by New York Life Insurance Company, covering the Bank Building (subject to the Bank's lease), the interest of Frank Lyon Company in the lease of the Bank Building, the interest of Frank Lyon Company in the lease of the land underlying the Bank Building, the interest of the Bank in the land underlying the Bank Building and in the adjoining Parking Facility.

As a further condition to making the permanent loan, New York Life has required that the Bank enter into a Consent and Agreement whereby the Bank makes certain representations to New York Life with respect to the Bank's corporate status, its financial affairs, its authority to enter into the various transactions contemplated, its authority to enter into the various leases, its title to the land underlying the Bank Building and the Parking Facility, cost of the Bank Building and Parking Facility, proper execution of the various instruments, and the right of New York Life to inspect the property subject to the lien of the deed of trust and to examine the books of account of the bank.

As your formal approval of the foregoing is required by First National City Bank to close the construction loan, I would greatly appreciate your indicating your approval on the attached copy of this letter in the space that I have

provided. Any questions that you may have on this financing arrangement I will be happy to go into detail with you.

Sincerely,

/s/ Ed Penick
President

The plan of financing your building as outlined in this letter has my approval.

April 23, 1968
(Date)

Federal Reserve Bank of St. Louis

By O. O. Wyrick
Vice President

P. Ex. 42

FEDERAL RESERVE BANK OF ST. LOUIS
P. O. Box 442
ST. LOUIS, MISSOURI 63166

April 19, 1968

Mr. Edward M. Penick, President
Worthen Bank and Trust Company
P. O. Box 1681
Little Rock, Arkansas 72203

Dear Mr. Penick:

This refers to your letter of April 16, 1968, regarding interim and permanent financing of the new bank building under construction and requesting our approval of the program as outlined in your letter.

On the basis of previous understandings that the bank's investment in bank premises will not exceed its capital stock, my letter of September 13, 1967, advised that the propsed new building project would not require prior approval under the provisions of Section 24A of the Federal Reserve Act of the Board of Governors of the Federal Reserve System. At that time it was understood that the bank would have no financial interest in the building and would furnish none of the funds for its construction.

Your letter of April 16, 1968, indicates that Frank Lyon Company shall arrange for the construction loan. In order that we may be in a position to execute the approval requested in your letter the following information is required: (1) please advise us as to the present carrying or book value of all bank premises (all offices) including leasehold improvements; (2) caption or title and present balance in "construction account"; (3) a projection as to highest amount construction account will reach before the bank is reimbursed by Frank Lyon Company; and (4)

your assurance that the book value of bank premises plus the balance at any time in the construction account will not exceed the bank's capital stock.

Upon receipt of this information and assurances, we will be a position to act upon your request.

Very truly yours,

/s/ O. O. WYRICK
O. O. Wyrick
Vice President

P. Ex. 43

WORTHEN BANK AND TRUST COMPANY
LITTLE ROCK, ARKANSAS

April 22, 1968

Mr. O. O. Wyrick, Vice President
Federal Reserve Bank of St. Louis
P. O. Box 442
St. Louis, Missouri 63166

Dear Mr. Wyrick:

In answer to the questions in your letter of April 19 concerning the book value of our premises, we have a total book value, including what we refer to as "new bank building" of $3,684,883.34. This amount includes all lands, buildingsand leasehold improvements of all of our offices that are owned by the bank, or leased by the bank. Of this $3,684,883.34, we have in the "new bank building account" $2,113,697.10. This would compare to what you referred to as "construction account". As you can see, we are almost out of construction money because we have your request and our agreement that the total in these accounts would not exceed the book value of the bank capital stock which is $4,000,000.00. So in answer to that question, we have the difference between what is now in the book value of all lands, buildings and leasehold and $4,000,000.00 to go. We are not going over the $4,000,000.00.

In reality we have worked in reverse of your questions. We have first said that we would not have over $4,000,000.00 in this account and we have worked backwards from that to keep a tight string on the "new bank building account". The thing that is putting the most pressure on us is the fact that the mechanics of closing this purchase and lease back with Frank Lyon Company as the future owner, First National City in New York as the interim lender, New York Life Insurance as the permanent lender and

Worthen Bank as the present owner but future tenant, is most complicated and there are a myriad of lawyers deciding on all manner of future contingencies.

It is my understanding that all of the points of disagreement have been ironed out and it is a matter of mechanically typing up the paper work and signing them. I have been assured that this will happen within the next week or ten days in New York.

I believe that this is the detail information that you requested and the assurances that you needed in order to act upon our request of April 16.

Sincerely,

/s/ JAMES PENICK, JR.
Executive Vice President

P. Ex. 44

FEDERAL RESERVE BANK OF ST. LOUIS
P. O. BOX 442
ST. LOUIS, MISSOURI 63166

April 23, 1968

Mr. James Penick, Jr.
Executive Vice President
Worthen Bank & Trust Company
P. O. Box 1681
Little Rock, Arkansas 72203

Dear Mr. Penick:

This will acknowledge and thank you for your letter of April 22 in response to my letter of April 19 regarding your bank construction program.

In the light of our previous understandings and the information submitted in your letters of April 16 and April 22, I am pleased to grant my approval to the plan of financing your new bank building as requested. Enclosed is the signed copy of your letter of April 16.

Kind personal regards.

Sincerely,

/s/ O. O. WYRICK
O. O. Wyrick
Vice President

P. Ex. 45

WORTHEN BANK BUILDING

COMPARISON OF ANNUAL RENT WITH TOTAL OF DEPRECIATION AND INTEREST FOR FIRST 10 YEARS

Year	Annual Lease Payments	Depreciation Straight-line	Interest Expense	Total Depreciation & Interest	Excess Over Rent
1970	$582,324.12	$169,777.78	$479,385.91	$649,163.69	$66,839.57
1971	,,	,,	472,274.12	642,051.90	59,727.78
1972	,,	,,	464,670.00	634,447.78	52,123.66
1973	,,	,,	456,539.48	626,317.26	43,993.14
1974	,,	,,	447,846.08	617,553.86	35,299.74
1975	,,	,,	438,550.86	608,328.64	26,004.52
1976	,,	,,	428,612.15	598,389.93	16,065.81
1977	,,	,,	417,985.42	587,763.20	5,439.08
1978	,,	,,	406,623.00	576,400.78	(5,923.34)
1979	,,	,,	394,474.00	564,251.73	(18,072.39)

Annual Lease Payments beginning 12/1/1980 thru 11/30/1994— $613,157.28

Annual Lease Payments Thereafter $300,000.00

P. Ex. 46

WORTHEN BANK & TRUST CO.
RENT SCHEDULE ON WORTHEN BUILDING
1994

Purchase Option price of building in 1994		$2,145,935
I. Average rate of return on capital	10.1%	
Annual return on $2,145,934	$216,739	
Total return for 40 years		$8,669,560
OR:		
II. Rent expense (net) from 1994-2034:		
5 yrs. @ $200,000—$1,000,000		
5 yrs. @ 150,000— 750,000		
5 yrs. @ 100,000— 500,000		
25 yrs. @ 50,000— 1,250,000		
Total rent (40 yrs.)		3,500,000
Accumulative dollar advantage of continuing to lease The Worthen Building		$5,169.560

P. Ex. 47

LEASE

THIS LEASE is made as of the first day of May, 1968, between T. H. MAYER and NICHOLAS M. MAYER, hereinafter referred to collectively as "lessor", and SAFEWAY STORES, INCORPORATED, a Maryland corporation, hereinafter referred to as "lessee, on the following terms and conditions:

1. *Premises, Term.* Lessor hereby leases to lessee the following described real property and improvements thereon in the City of Little Rock, County of Pulaski, and State of Arkansas:

Tract #1: A parcel of land in the Northwest Quarter of the Northeast Quarter and Northeast Quarter the Northwest Quarter, Section 2, Township 1 North, Range 13 West in Little Rock, Pulaski County, Arkansas. More particularly described as:

Commencing at the Southwest corner of Northwest Quarter, Section 2, Township 1 North, Range 13 West; thence North 190.74 feet to a point on the Easterly Right of Way of Rodney Parham Road for a point of beginning; thence North 38 degrees 43 minutes 30 seconds West along said Right of Way Line 186.20 feet; thence North 39 degrees 44 minutes 30 seconds West along said Right of Way Line 108.32 feet; thence North 88 degrees 32 minutes 00 seconds East 186.25 feet; thence North 107.00 feet; thence South 89 degrees 49 minutes 30 seconds East 185.00 feet; thence South 138.00 feet; thence North 89 degrees 49 minutes 30 seconds West 3.00 feet; thence South 256.76 feet; thence South 88 degrees 51 minutes 40 seconds West 137.09 feet to the Easterly Right of Way Line of Rodney Parham Road; thence North 38 degrees 11 minutes 00 seconds West along said Right of Way line 72.92 feet to the point of beginning, containing 2.133 acres, more or less.

Together with a nonexclusive easement for ingress and egress for driveway purposes for the join use of lessor and lessee, their tenants, subtenants, employees, customers and invitees over the following-described parcel of land.

Tract #2: A parcel of land in the Northwest Quarter of the Northeast Quarter, Section 2, Township 1 North, Range 13 West, Little Rock, Pulaski County, Arkansas. More particularly described as:

Commencing at the Southwest corner of the Northwest Quarter of Northeast Quarter, Section 2, Township 1 North, Range 13 West, thence North 190.74 feet to a point on the Easterly Right of Way Line of Rodney Parham Road; thence South 38 degrees 11 minutes 00 seconds East along said Right of Way Line 72.92 feet; thence North 88 degrees 51 minutes 40 seconds East, 137.09 feet to the point of beginning and the Southeast corner of Tract #1; thence North 74.76 feet; thence South 41 degrees 04 minutes 05 seconds East 249.76 feet; thence South 0 degrees 06 minutes 30 seconds East, 10.00 feet to the North Right of Way Line of West Markham Street; thence South 88 degrees 54 minutes 00 seconds West along said Right of Way Line 41.93 feet; thence North 38 degrees 11 minutes 00 seconds West, 158.80 feet; thence South 88 degrees 51 minutes 40 seconds West, 24.01 feet to the point of beginning, containing 0.186 acres, more or less.

All as shown on Exhibit "A" attached hereto and made a part hereof which said Exhibit sets forth the leased premises in red color, the area retained by lessor in green color, the parking area subject to common use of all tenants in blue color, and the Conoco lease in yellow color.

To Have and To Hold the leased premises with all appurtenances, for an original term of twenty (20) years from May 1, 1968, to April 30, 1988, both inclusive. In the event the lessee deems it necessary to extend the original terms of this lease in connection with its sale of the leased

premises for leaseback or in connection with financing, by mortgage or otherwise, lessee shall have the right to extend the said term for such period as lessee deems necessary, but in no event beyond the 30th day of April, 1990.

2. *Rent.* Lessee agrees to pay rent in the sum of Eight Hundred Thirty-three and 34/100 Dollars ($833.34) on the first day of each calendar month during the original term, by checks or drafts payable to C. V. Barnes, Agent, and mailed to him at 733 Pyramid Building, Little Rock, Arkansas, or as designated in writing by lessor, with proration for any fractional calendar month.

3. *Taxes, utility charges, etc.* Lessee agrees to pay all charges for electricity, gas, heat, water, sewer, telephone and other utility services used on the leased premises and all taxes and assessments on the leased premises and on all improvements construed thereon, for the period while this lease is in effect, with taxes and assessments to be prorated to the first and last days of the term.

4. *Construction and Alteration of Building Improvements.* Lessee may, at lessee's expense, construct on the leased premises any improvements, including, without limitation, a store building and parking area, and make such repairs, additions, alterations and improvements thereto as lessee may deem desirable. All improvements so constructed by lessee shall be primarily for the purpose of operating a modern retail supermarket and purposes reasonably related thereto. The store building shall provide not less than 15,000 square feet and shall be constructed within a period of two (2) years from the date hereof, exclusive of delays on account of Acts of God, riots, strikes, and shortage of construction material, provided, however, that if lessee does not commence the construction of such store building within a period of two (2) years from the date hereof, upon expiration of the said period and at any time thereafter prior to the commencement by lessee of the construction of such store building lessor may

terminate this lease upon giving to lessee thirty (30) days written notice of cancellation in the manner hereinafter provided. Lessor shall not be obligated to maintain the leased premises or to maintain, replace or rebuild any improvements thereon. All improvements constructed on the leased premises by lessee, and all additions, alterations and improvements thereto made by lessee, shall not become a part of the realty even if affixed to the realty but shall remain the exclusive personal property of lessee during the term of this lease and during the term of any extension or renewal of this lease by the exercise of one or more renewal options under the provisions of paragraph 19 hereof. On surrendering possession to lessor, all building improvements then located on the leased premises shall become the exclusive property of the lessor. Lessee agrees not to permit any liens to stand against the leased premises for work done or materials furnished to lessee, provided, however, that lessee may contest the validity of any such lien, but upon a final determination of the validity thereof, lessee shall cause such lien to be paid and released of record without cost to lessor.

In order that lessor may provide for the proper use of the area retained by lessor as indicated in green on the plat attached hereto, lessee will furnish to lessor, for its prior approval, a copy of lessee's drainage, grading, and paving plans for the leased premises, which approval by lessor will not be unreasonably withheld.

In the event that lessee undertakes to pave or hard surface the access area from West Markham Street to the common area and if and when lessor leases any part of its premises adjacent to the common area as indicated on the plat attached hereto, then in such event lessor will reimburse lessee for the costs of paving or hardsurfacing the said access area in an amount not to exceed forty cents (40¢) per square foot.

In the event that the City requires the construction of a screen type or other type of fence along the perimeter of the area retained by lessor indicated in green on the plat attached hereto when lessor constructs its improvements on the leased premises, then in such even lessor will, without cost to lessee, construct, or cause to be constructed, such fence as may be required by the City.

5. *Lessee's Fixtures.* Lessee may install in the leased premises such fixtures and equipment as lessee deems desirable and all of said items shall remain lessee's property whether or not affixed to the leased premises. Lessee may remove the said items from the leased premises at any time but shall repair any damage caused by removal.

6. *Common Area, Maintenance.* That part of the leased premises constructed by lessee and used by it as a parking area (indicated in blue color on the plat attached hereto and marked Exhibit "A" and hereinafter sometimes referred to as "common area") shall be for the common use as a parking area by all tenants of lessor. Until there are other tenants of lessor to use the common area, lessee will, at lessee's expense, maintain the common area in a manner suitable to it. Lessee may require any additional tenants of lessor who use the common area to contribute reasonably to the costs incurred by lessee in lighting and maintaining the common area not to exceed, however, a contribution in excess of the proportion which the area of the premises leased to each such other tenant bears to the total area of all such leased premises exclusive of the common area, and lessor will so provide in its leases to any such other tenant or tenants.

Such common area will never at any time be less than one parking space for each two hundred (200) square feet of retail sales area, provided, however, that nothing herein contained shall prevent lessee from expanding its building to cover that area designated as ramp and service drive on the plat attached hereto. Lessor, lessee, and all other ten-

ants of lessor using the said common area shall have a common right of ingress and egress thereto for themselves and for the use of their leased premises. Lessee shall certify to lessor monthly, or at such other times as the parties hereto may agree, the amount of its actual net accounting costs for such lighting and maintenance, and lessor will reimburse lessee in the amount of such costs to be borne by the other tenants of lessor.

7. *Indemnification.* Lessee agrees to indemnify lessor and save lessor harmless from any and all liability, damage, expense, causes of action, suits, claims or judgments arising from injury to person or property on the leased premises or on the adjoining streets and sidewalks, except if caused by the willful or negligent act of lessor or lessor's agents or employees.

8. *Assignment and subletting.* Lessee may assign this lease or sublet the whole or any part of the leased premises but lessee shall remain liable to lessor for the full performance of lessee's obligations hereunder.

9. *Holding over.* If lessee remains in possession of the leased premises after the expiration of this lease and rent is paid and accepted, such possession shall create a month-to-month tenancy on the terms herein specified which tenancy may be terminated by either party by thirty (30) days written notice to the other party.

10. *Default.* If lessee remains in default more than thirty (30) days after receipt of lessor's notice specifying such default, lessor may declare the term ended and reenter the leased premises with or without process of law. If lessor remains in default for more than thirty (30) days after receipt of lessee's notice specifying such default, lessee may either (a) incur any expense necessary to perform any obligation of lessor specified in such notice and deduct such expense from the rents to become due or (b) declare the term ended and vacate the leased premises

and be relieved of all further obligations hereunder. The performance of each and every covenant and agreement in this lease on the part of lessor shall be a condition precedent to lessor's right to collect rent or enforce this lease.

11. *Lessor's title.* Lessor covenants that lessor has lawful title to the leased premises and full right to make this lease and the lessee shall have quiet and peaceful possession of the leased premises. Lessor covenants that, at the commencement of the term, the leased premises will be free from encumbrances not agreed to in writing by lessee and that there will be no title or other matters not agreed to in writing by lessee, which will restrict the erection of any building or improvements as herein provided or the operation of a modern retail super-market (including the sale of malt and vinous beverages if not prohibited by law and if lessee obtains all necessary licenses and/or permits at lessee's expense) on the leased premises. Lessor covenants that the leased premises will extend to the street line on all adjacent streets and alleys, that there will be no encroachment of improvements from or onto adjoining property and that lessee will be able to obtain, at lessee's expense, a survey which will confirm said covenants. Lessor also covenants that lessee will be able to obtain, at lessee's expense, a leasehold policy of title insurance from a title insurance company satisfactory to lessee, insuring lessee that its leasehold interest is superior to and free and clear of all matters not agreed to in writing by lessee. In the event of a violation of any of the foregoing covenants or the existence of facts at variance with such covenants, lessee may cancel this lease by notice to lessor.

12. *Condemnation.* If any portion of or interest in the leased premises shall be taken or damaged by condemnation under any right of eminent domain or any transfer in lieu thereof, other than for the purpose of widening presently existing streets not to exceed fifteen (15) feet on the side of each streets, lessee may either (1) remain in

possession with this lease continuing as to the remaining portion of the leased premises but with the rental under paragraph 2 reduced in the ratio which the remaining land area in the leased premises bears to the total land area preceding such condemnation, or (2) if such taking shall render the leased premises substantially unsuitable for lessee's business operations, cancel this lease as of the date of such condemnation by notice to lessor within one hundred eighty (180) days after said date even though lessee may not have constructed any improvements on the leased premises. If this lease is so terminated, lessee shall deliver to lessor a bill of sale transferring the title to any building improvements on the leased premises to lessor. In the event of any condemnation and whether or not lessee elects to terminate this lease, lessee shall be entitled to any and all awards or payments made in the condemnation proceedings in respect to any damage to (a) lessee's leasehold interest, (b) any improvements constructed on the leased premises by lessee to the extent of lessee's equitable interest therein in the proportion that the unexpired term as it may have been extended by the exercise of options to extend bears to the period of fifty (50) years, and (c) lessee's fixtures and equipment which lessee would be entitled to remove upon the expiration of the demised term.

13. *Cancellation.* Provided lessee has theretofore constructed a building on the leased premises and is not in default under any of the terms of this lease, lessee may terminate this lease at any time by giving lessor thirty (30) days' notice and delivering to lessor a bill of sale adequate to transfer to lessor clear title to all building improvements on the leased premises on the effective date of termination. Such termination shall discharge both lessor and lessee from further liability under this lease and this lease shall be of no further force or effect.

14. *Lessee's right of first refusal.* If lessor determines to sell all or any part of the leased premises, other than

in the process of a regular liquidation of lessor, and receives an acceptable bona fide offer therefor, lessor, before making any agreement to sell, will give notice to lessee stating lessor's desire to sell and the amount of such offer. Lessee shall have the exclusive right for thirty (30) days after receiving such notice to purchase the premises to which such offer refers at the amount of said offer, or for any lesser amount which lessor may be willing to accept. If lessee fails to exercise the said right and the premises are sold by lessor to a third party, such sale shall nevertheless be made subject to this lease, including this paragraph, and said right shall be applicable to any and all subsequent offers to purchase received by lessor's successors and assigns.

15. *Lessor's Right of First Refusal.* While at any time lessee holds the title to the improvements, alterations or additions constructed by lessee on the leased premises, if lessee determines to sell all or any part of the said improvements, alterations, or additions and receives an acceptable bona fide offer therefor, lessee, before making any agreement to sell, will give notice to lessor stating lessee's desire to sell and the terms, conditions and amounts of such offer. Lessor shall have the exclusive right for thirty (30) days after receiving such notice to purchase the said improvements, alterations or additions to which such offer refers upon the terms, conditions and at the amount of said offer, or for any lesser amount which lessee may be willing to accept. If lessor fails to exercise the said right and the premises are sold by lessee to a third party, such sale shall nevertheless be made subject to this lease, not, however, including this paragraph number 15.

16. *Competitive business.* Lessor covenants not to permit over 2,000 square feet of sales area (including aisle space adjacent thereto) in any other premises owned or controlled by lessor and situate within 1,000 feet of the

leased premises to be devoted to the sale of food for off-premises consumption. Lessor contemplates the construction of a shopping center on premises controlled by lessor and situate within 1,000 feet of the leased premises, said premises being herein referred to as the "shopping center". Lessee covenants that the leased premises shall not be used by its assignee or subtenants for any business purpose which conflicts with any exclusive clause contained in the lease of any tenant in the shopping center, provided lessee has been informed in writing by lessor of any such exclusive clause prior to the date on which lessee commences to use the leased premises for or permits the use of the premises for such conflicting purpose.

17. *Vacancy of Premises.* In the event that lessee should determine to vacate the leased premises or to discontinue its operation therein prior to the termination of the term herein demised, or any extension thereof, lessee shall give to lessor four (4) months' prior written notice of intention to vacate. If thirty (30) days prior to the date on which lessee has determined to vacate the leased premises, the said leased premises shall not have been sublet, lessor is hereby empowered as agent of lessee to sublet the leased premises, in whole or in part, and to keep the leased premises, in whole or in part, subletted, for and in the name of lessee, and on its behalf, at the highest rental reasonably obtainable by lessor. In the event such rental is less than the rental lessee is obligated to pay to (1) the lessor herein and (2) its leasehold improvements lessor (which rental payable to the leasehold improvements lessor during the term of the leasehold improvements lease shall not be higher in any year than for any preceding year of the said term), including all of lessee's obligations to pay taxes, insurance premiums, and maintenance costs, lessor shall reimburse lessee for the difference between the sublease rental and lessee's rental obligation as set forth in terms

(1) and (2) of this paragraph, it being the intention of the parties hereto that lessee shall suffer no monetary loss by reason of any sublease made by lessor as agent of lessee. In the event the leasing by the lessor as agent of lessee as hereinabove provided occurs at such time lessee is the owner of the ground lease and the leasehold improvements, then in such event, lessor shall reimburse lessee for the difference between the sublease rent and the amount required to be paid by lessee under this ground lease which shall include rent, taxes, cost of insurance premiums, and any maintenance which is required to be performed by lessee, plus the fair rental value of the building improvements owned by lessee and included in the aforesaid lease made by lessor as agent for lessee. At its option, lessee shall have the right to offset against rental payable by lessee under this ground lease, any amount for which lessee is entitled to reimbursement by lessor under the provisions of this paragraph.

In the event lessee vacates the leased premises or discontinues its operations as hereinabove set forth, and in the further event that lessee cancels its leasehold improvements lease by offer to purchase the leased premises from its leasehold improvements lessor, and in the further event that lessee does in fact repurchase said leased premises, then in such event, lessee agrees that the provisions of paragraph 20 of this ground lease shall be of no further force or effect and that this lease shall terminate at the expiration of the original term hereof.

Lessee further agrees that, in addition to the rights of the lessor as set forth in this paragraph 17, lessor shall have the right, but only under the circumstances as set forth in this paragraph 17, to require lessee to assign to lessor, lessee's interest as lessee under the leasehold improvements lease referred to in paragraph 15 hereof, subject to the following conditions:

1. Lessor will assume all of the obligations of lessee as lessee under said leasehold improvements lease and will agree to hold lessee harmless from any and all liability.

2. There is attached hereto as Exhibit "B" a copy of Article 6 as it appears in lessee's standard form of leasehold improvements lease. If language comparable to the language shown in Exhibit "B" is included in lessee's leasehold improvement lease, lessee shall have the right to include in said assignment a provision to the effect that the rights granted to the lessee in Subsection III and in the last paragraph thereof shall not be exercised by the assignee and a further provision that in the event that assignee exercises the rights provided in Sub-sections I and II thereof assignee will not undertake any such alterations and/or construction in excess of $10,000 or without first presenting to the lessor the plans and specifications therefor and obtaining lessors approval and consent, which approval and consent in either of such events shall not be unreasonably withheld.

3. The leasehold improvements lease will contain provisions permitting the lessee to cancel the leasehold improvements lease by offer to purchase. The assignment of lease will provide that the assigns will have no right to cancel said leasehold improvements lease by offer to purchase until assignee has deposited in escrow an amount sufficient to pay the repurchase price and costs incidental to such repurchase, or has provided lessee with evidence satisfactory to lessee of assignee's ability to pay said repurchase price.

Nothing in this paragraph, however, except payment of the rent in full, shall relieve lessee of its obligation to pay the rental reserved herein for the full demised term or of any extension thereof.

18. *Compliance with laws.* Lessee agrees not to violate any law, ordinance, rule or regulation of any governmental authority having jurisdiction of the leased premises. Lessee may contest the validity of such law, ordinance, rule or regulation but shall indemnify and hold lessor harmless against the consequences of any violation thereof by lessee.

19. *Notices.* Any notice provided for herein shall be given by registered or certified United States mail, postage prepaid, addressed, if to lessor, to the person to whom the rent is then payable at the address to which the rent is then mailed, and, if to lessee, to it at P. O. Box 660, Oakland, California. The person and the place to which notices are mailed may be changed by either party by notice to the lessor gives lessee hereunder shall also be given by registered or certified United States mail to such other persons and at such places as lessee may designate in writing. Upon lessee's written request, and provided lessor can do so truthfully, lessor will certify in writing to all persons designated by lessee (1) that lessee has performed all of lessee's obligations and is not in default under this lease, (2) that this lease is in full force and effect and (3) that each person receiving such certification may rely thereon for all purposes. Lessor further agrees that in the event of any default by lessee under this lease, any mortgage or other holder of a security interest in lessee's leasehold or improvements and/or any assignee or sublessee of lessee may cure such default within the time allowed lessee for same hereunder and continue this lease in full force and effect.

20. *Renewal Options.* With the expiration of the term hereby demised, if this lease shall then be in full force and effect and the lessee shall have complied, in all respects, with the agreements, conditions, covenants and terms hereof, lessee may, upon not less than one hundred eighty (180) days prior written notice given by lessee to lessor, at its

option, extend the term of this lease for six (6) additional periods of five (5) years each on the same terms and conditions for an annual rental for each renewal term equal to the fair rental value of the land (exclusive of improvements constructed by lessee) as may be agreed upon by the parties hereto, and, in the absence of such agreement, as may be determined by arbitration by three arbitrators, one of whom shall be appointed by each party hereto and the third of whom shall be appointed by the other two.

21. *Remedies cumulative.* No remedy herein conferred upon or reserved to lessor or lessee shall exclude any other remedy herein or by law provided, but each shall be cumulative and in addition to every other remedy given hereunder or now or hereafter existing at law or in equity or by statute.

22. *Lessor's right to insure.* Lessor may, at lessor's option and expense, maintain hazard insurance as its interests may appear covering any or all of the improvements constructed on the leased premises. In the event of any loss covered by any such insurance, then proceeds resulting therefrom shall belong exclusively to lessor, and lessor shall not be required to expend any of the said proceeds in restoring any improvement or in repairing any damage thereto.

23. *Lessor's right to lease adjoining areas.* Except as provided in paragraph 16 hereof, lessor retains the right to lease its lands adjoining the premises herein leased to such other tenant or tenants and upon such other terms as is may elect other than for the purpose of operating a modern retail super-market or for a purpose in competition with lessee.

24. *Short form lease.* This lease shall not be recorded but it is agreed that, upon request by either party the parties will execute a short form of this lease which may be recorded by either party.

25. *Paragraph headings.* The paragraph headings of this lease are inserted only for reference and do not affect the terms and provisions hereof.

26. *Rights of successors.* All of the rights and obligations of the parties under this lease shall bind and inure to the benefit of their respective heirs, executors, administrators, successors, sub-lessees, transferees and assigns.

In Witness Whereof, lessor has executed this instrument, and the lessee has caused its corporate name to be hereunto subscribed and its corporate seal to be hereunto affixed by its officers thereunto duly authorized, as of the date hereinabove first written but actually on the 10th day of May, 1968.

/s/ T. H. Mayer
T. H. Mayer

/s/ Nicholas M. Mayer
Nicholas M. Mayer

(Lessor)

Safeway Stores Incorporated

(A Maryland corporation)

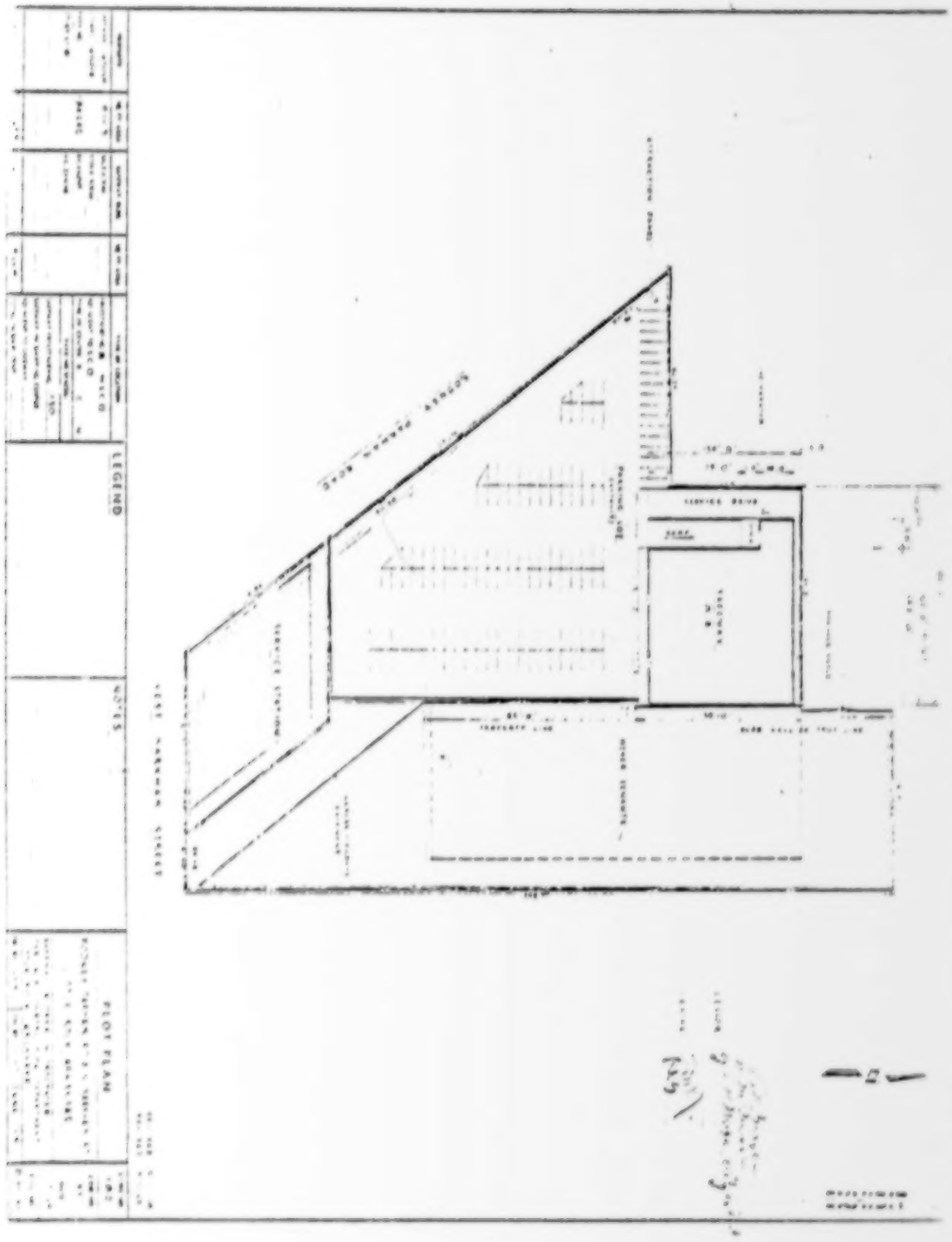
(Seal)

By: /s/ [illegible]
Title: *Assistant Vice President*

By: /s/ [illegible]
Title: *Assistant Secretary*

(Lessee)

(Acknowledgments Omitted in Printing)



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P. Ex. 48

INTER-OFFICE COMMUNICATION

To: Mr. James A. Rowland

For: Mr. W. H. Dodge

Location: Little Rock Division

From: Mr. B. H. Dean, Jr.

Location: Real Estate Finance
Administrative Office

Date: May 13, 1969

Subject: Store #182—105 N. Rodney Parham Road
Little Rock, Arkansas
Your letter of March 17, 1969

We have recently increased our sale-leaseback rental because of the increase in interest rates and our sale-leaseback terms are now as follows:

1. A twenty-year original term during which we pay a constant annual rental equal to 9.49% of the sale price of the property, such rental being in monthly installments in advance
2. Six five-year renewal options at a constant annual rental equal to 3% of the sale price of the property
3. We reserve the right to cancel under Article Fourteenth if we are going to abandon our operations on the premises, but, upon such cancellation, must offer to repurchase for the unamortized portion of the original sale price computed in accordance with the schedule attached to the lease, copy of which is enclosed
4. We do not pay real estate commissions on our sale-leaseback transactions and, in the event there are any such commissions, the same must be paid by the purchaser.

If our ground lessors, Messrs. T. H. Mayer and Nicholas M. Mayer, will be interested in purchasing the improvements on the above terms, we will be glad to enter negotiations with them for appropriate revisions in the ground lease dated May 1, 1968.

On the other hand, if Mr. Barnes has other clients who would be interested in purchasing the improvements on the above terms, subject to the ground lease, we will be pleased to furnish him with copies of our standard form of leasehold improvements lease, etc.

In either of the above connections, I note that, under the provisions of Paragraph 1, the Mayers have agreed to extend the original term of the ground lease for a period of twenty years from and after our sales of the improvements.

/s/ B. H. Dean, Jr.

This Lease, made as of the day of , 19 , between

,

hereinafter referred to as Lessor, and Safeway Stores, Incorporated, a Maryland corporation, hereinafter referred to as Lessee, relating to the real property leased by

,

hereinafter referred to as Landlord, by Lease dated the day of , 19 , recorded

,

hereinafter referred to as the Main Lease, to said Safeway Stores, Incorporated (hereinafter in its capacity as Lessee under the Main Lease sometimes referred to as Tenant), for a term of ( ) years commencing , and extending to and including the day of , 19 , with Tenant having the right to extend the term of the Main Lease for ( ) separate and additional pe-

riods of ( ) years each, which leasehold interest of Lessee under the Main Lease has been assigned to Lessor.

Witnesseth: That in consideration of the mutual agreements herein contained, the parties hereto do hereby covenant to and with each other as follows:

Article First (Property description): Lessor does hereby lease and sublease to Lessee the following described real property and the buildings and improvements thereon in the City of , County of , State of , designated as

, to-wit:

To Have and To Hold the above described premises, together with the tenements, hereditaments, appurtenances and easements thereunto belonging, at the rental and upon the terms and conditions herein stated, for an original term of ( ) years, commencing with the first day of , 19 , and extending to and including the last day of , 19 .

Article Second (Rent): Lessee does hereby agree to pay to Lessor, as the rent of the leased premises, the sum of Dollars ($) on the first day of each calendar month during said original term. Said payments shall be made by checks or drafts payable to

,

and mailed to , at

or by checks or drafts made payable to any other payee or mailed to any other address which Lessor, or any successor in interest of Lessor, may in writing designate. The rent for any fractional calendar month shall be prorated and paid on the first day of such fractional month.

ARTICLE THIRD (Warranties and covenants of Lessee): (a) Lessee represents and warrants to Lessor that the Main Lease is a valid and existing lease which is in full force and effect and that no default by Tenant exists under the Main Lease.

(b) Lessee shall comply, at its own cost and expense, with all the terms, covenants and conditions of the Main Lease, and shall pay, perform and discharge all duties and obligations whatsoever which are imposed upon Tenant under the Main Lease, including the obligation to indemnify Landlord thereunder, to the end that Lessor as assignee of Tenant's interest under the Main Lease, shall have no responsibility for compliance with the provisions of the Main Lease and shall be fully exonerated from all liability thereunder. Lessee will not cause or permit to occur any default under the Main Lease which would entitle Landlord to terminate the Main Lease.

(c) Lessee agrees that this lease is subject to all of the terms and conditions of the Main Lease.

ARTICLE THIRD A (Taxes, utility charges, etc.): Lessee agrees that it will pay all charges for electricity, water, gas, telephone and other utility services used on the leased premises. Lessee further agrees to pay all taxes and assessments upon the leased premises which are payable during the original lease term or any renewal thereof. Taxes assessed during the term, but payable in whole or in installments after the termination of this lease, and assessments which are covered by bond, shall be adjusted and prorated and Lessor shall pay the prorated share thereof for the period subsequent to the term, and Lessee shall pay the prorated share thereof for the term of this lease.

Lessee also agreed to pay as additional rent any and all sums required to be paid to Landlord, or other party designated by Landlord, as rent pursuant to the provisions of the Main Lease, which payments shall be made directly to Landlord or said other party and shall be made by checks

payable to the order of Landlord or said other party. Lessee shall also make all other payments of every kind and description required to be made by Tenant under the Main Lease.

At the request of Lessor, Lessee shall, within sixty (60) days after such request, produce and exhibit to Lessor satisfactory evidence of the payment of any tax assessment or other charge constituting a lien on the leased premises which has become due and payable.

ARTICLE FOURTH (Installation and removal of fixtures; painting, signs, etc.): Lessee may place or install on and/or in the leased premises such fixtures and equipment as it shall deem desirable for the conduct of business therein, and may paint the building improvements such colors as it elects. Lessee shall have the exclusive right to paint and erect or authorize such signs as are permitted by the Main Lease in and over the leased premises and on the outside of the building improvements thereon. Personal property, fixtures and equipment used in the conduct of Lessee's business (as distinguished from fixtures and equipment used in connection with the operation and maintenance of the building improvements) placed by Lessee or any subtenant or any predecessor in interest on or in said premises (even though placed prior to the commencement of said term) shall not become a part of the realty, even if nailed or screwed or otherwise fastened to the premises, but shall retain their status as personalty and may be removed by Lessee at any time. Lessee may obliterate any signs or color effects installed by it. Any damage caused the leased premises by the removal of such property shall be repaired by Lessee at its expense.

ARTICLE FIFTH (Lessee's assumption of liability): Lessee agrees that it will indemnify and save Lessor harmless from any and all liability, damage, expense, cause of action, suits, claims or judgments arising from injury to person or property on the leased premises, or upon the

adjoining streets and sidewalks. Lessee further agrees to indemnify and save Lessor harmless from any and all liability arising from any failure by Lessee to perform any of the agreements, terms, covenants or conditions of the Main Lease or of this lease on Lessee's part to be performed or in any manner arising out of or connected with the leasehold estate under the Main Lease. In addition, Lessee agrees to furnish Lessor with a certificate extending to Lessor the public liability insurance coverage maintained by Lessee.

Article Sixth (Repairs, alterations and improvements; state of repair on termination; future development and Lessee's options with respect thereto): Lessee agrees that Lessor shall be under no obligation to rebuild, replace, maintain or make any repairs to the leased premises, or to the improvements thereon during the lease term or any renewal thereof. Lessor agrees that Lessee may make, or permit to be made, such alterations and improvements to the leased premises as Lessee may deem desirable for the use thereof and may at Lessee's option, and without cost to Lessor, at any time and from time to time during the original lease term, or during any option period hereinafter provided for, do any one or more of the following:

I. Alter or remodel any building or improvements on the leased premises, provided the market value of any building or improvements so altered or remodeled is not adversely affected thereby, and/or

II. Construct an addition, or additions thereby, and/or

III. Raze any building or improvement situated on the leased premises and erect in the place thereof, a new building or improvement which shall be of a value not less than the market value of the building or improvement so razed at the time of its demolition, and/or

IV. Construct separate additional buildings thereon. Lessee agrees that it will not permit any mechanics', ma-

terialmen's or other liens to stand against the leased premises for work or materials furnished Lessee in connection with any such alterations, remodeling, additions or new construction, it being provided, however, that Lessee shall have the right to contest the validity of any such lien or claim, but upon a final determination of the validity thereof, Lessee shall immediately pay any judgment or decree rendered which may be a lien upon the leased premises or the leasehold estate against Lessee, with all proper costs and charges, and shall cause any such lien to be released of record without cost to Lessor. At the expiration or termination of this lease, or any extension or renewal thereof, Lessee shall leave the leased premises in good condition, allowance being made for ordinary wear and tear and damage by fire or other casualty excepted, and Lessee shall not be required to restore the leased premises to the condition in which the leased premises are in as of the commencement of the term hereof, it being agreed that Lessor shall accept the leased premises with such alterations, remodeling, additions or new construction as may have been made pursuant to the authorization contained in this article.

Should Lessee, during the original term hereof, alter, remodel, add to or construct new improvements pursuant to the provisions of subparagraphs I, II or III hereof, and provided the cost thereof is Twenty-Five Thousand and No/100 Dollars ($25,000.00) or more, Lessee shall, on completion of said improvements, offer to sell the same to Lessor for an amount not greater than the cost thereof. Should Lessor accept Lessee's offer, which acceptance shall be made in writing within sixty (60) days of the date of such offer, Lessor shall, within forty-five (45) days after Lessor's written acceptance thereof, pay the purchase price to Lessee and enter into a lease modification agreement covering the property hereby leased and such new improvements. The lease modification agreement shall

(1) provide for the payment, during the balance of the original term, of additional rental at Lessee's rental rate then in effect for sales of similar new properties, adjusted to reflect the difference in length of term; (2) increase the option rentals provided for in Article Twentieth hereof by an amount equal to one-twelfth (1/12th) of the purchase price of such new improvements multiplied by the rental rate then being paid by Lessee as rental during option terms, and (3) increase the purchase price provided for in Article Fourteenth hereof by an amount equal to the unamortized portion of said purchase price of such new improvements at the time of lease termination. Should Lessee's offer to sell such new improvements not be accepted by Lessor within said sixty (60) day period, Lessee shall have the option of permitting this lease to continue in effect without any modification or change whatsoever, or, in the alternative, Lessee may, at any time within six (6) months after the date of Lessee's offer to sell said new improvements, require Lessor to sell, convey and assign the leasehold estate under the Main Lease and the improvements located on the leased premises, to Lessee in the manner and upon the terms as set forth in Article Fourteenth hereof, except, however, that this lease shall in no event terminate until the leasehold estate under the Main Lease and the improvements located on the leased premises shall have been assigned, sold and conveyed to the Lessee and that the provisions of Article Fourteenth relative to Lessee discontinuing the use of the premises for grocery supermarket operations shall be inapplicable.

Article Seventh (Assigning and subletting): Lessee shall have the right to assign or transfer this lease or to underlease or sublet the whole or any part of said leased premises. Should Lessee assign this lease, it shall nevertheless remain liable to Lessor for full payment of the rent and Lessee's other obilgations under this lease.

Article Eighth (Holding over): If Lessee holds over or remains in possession of the leased premises after ex-

piration of this lease or after any sooner termination thereof, without any new lease of said premises being entered into between the parties hereto, or any option hereinafter contained being exercised by written notice, such holding over or continued possession shall, if rent is paid by Lessee and accepted by Lessor for or during any period of time Lessee holds over or remains in possession, create a tenancy from month to month only at the last monthly rental and upon the terms (other than length of term, or option for renewal, purchase or cancellation) herein specified, which may at any time be terminated by either party by thirty (30) days' written notice given to the other party.

Article Ninth (Quiet possession): Lessor covenants that Lessor is the owner of the leasehold estate under the Main Lease which it has acquired by assignment from Lessee and has full right to make this lease, and that so long as Lessor is the owner of such estate, Lessee shall have quiet and peaceful possession thereof as against any adverse claim of Lessor or any party claiming under Lessor, subject to all exceptions to title to the leased premises which may be set forth in the policy of leasehold title insurance about to be issued to Lessor in connection with the assignment of Lessee's interest as Tenant under the Main Lease to Lessor, and subject to Landlord's rights under the Main Lease.

Article Tenth (Lessee's default; Lessor's default): In case Lessee shall default in the performance of any covenant or agreement herein contained, and such default shall continue for fifteen (15) days after receipt by Lessee of written notice thereof given by Lessor, or the agent or attorney of Lessor, then Lessor, at the option of Lessor, may declare said term ended, and may re-enter upon the leased premises, either with or without process of law, and remove all persons therefrom. Lessee expressly agrees that the exercise by Lessor of the right of re-entry shall not be a

bar to or prejudice in any way any other remedies available to Lessor. In case Lessor shall default in the performance of any covenant or agreement herein contained, and such default shall continue for thirty (30) days after receipt by Lessor of written notice thereof given by Lessee, its agent or attorney, then no rent shall be paid or become payable under this lease for such time as such default shall continue after the expiration of said thirty (30) day period and Lessee, at its option, may (1) declare the term ended and vacate the leased premises and be relieved from all further obligations under this lease, or (2) pay any sum necessary to perform any obligation of Lessor hereunder and deduct the cost thereof, with interest, from the rents thereafter to become due hereunder.

Article Eleventh (Damage by fire, etc.): Lessee agrees that it will, during the original term hereof, or any renewal thereof, at its expense, keep in effect upon the leased premises, fire insurance with extended coverage endorsement, written by a responsible insurance company or insurance companies authorized to do an insurance business in the state in which the leased premises are located, in an amount equal to not less than ninety per centum (90%) of the insurable value of the building improvements thereon, said policy or policies of insurance to provide that payment for any losses covered under or by said policy or policies of insurance shall be made to Lessor and/or Lessee and/or any mortgagee and/or assignee designated by Lessor from time to time, as their respective interests may appear. Lessor agrees that in the event of loss of or damage to said building improvements by fire or other casualty during the original term or any renewal thereof, Lessee may, at its option, rebuild or repair said building improvements, in which event all insurance proceeds shall be paid by said insurance company or companies to and retained by Lessee. Should the fire or other casualty occur during the original term and Lessee elect not to rebuild or repair said building improvements, Lessee shall, within

ninety (90) days after such loss or damage, give written notice to Lessor of Lessee's intention to terminate this lease as provided for in Article Fourteenth hereof, and as a part of said notice shall offer to purchase the leasehold estate under the Main Lease and the improvements located on the leased premises upon the terms set out in said article. In the event said offer to purchase is accepted by Lessor and Lessor conveys, sells and assigns the leasehold estate under the Main Lease and the improvements located on the leased premises, all insurance proceeds shall be paid by said insurance company or companies to and retained by Lessee. However, should said offer to purchase not be accepted by Lessor and this lease be terminated as in said article provided, Lessee shall be deemed to any does hereby agree to relinquish all rights to the proceeds of any insurance in effect upon said building improvements and such proceeds shall be paid directly to Lessor by said insurance company or companies. Notwithstanding the foregoing, in the event any mortgagee requires that the proceeds be made payable to it, then, and in such event, the proceeds shall be so paid to such mortgagee upon condition that said mortgagee shall agree to pay the said proceeds to Lessee upon the restoration of the leased premises as in this article provided or upon the purchase of the leasehold estate under the Main Lease and the improvements located on the leased premises by Lessee as provided for in Article Fourteenth hereof.

Should the fire or other casualty occur during a renewal option term and Lessee elect not to rebuild or repair said building improvements, Lessee shall, within ninety (90) days after such loss or damage, give to Lessor a thirty (30) day notice, in writing, cancelling and terminating the renewal term then in effect. On expiration of said thirty (30) day notice, the renewal term shall cease and determine and all insurance proceeds shall be paid directly to Lessor by said insurance company or companies.

ARTICLE TWELFTH (Condemnation): In the event that any person or corporation, municipal, public, private or otherwise, shall at any time during the original term hereof condemn and acquire title to the leased premises, or any portion thereof, or to any easement therein, in or by condemnation proceedings pursuant to any law, general, special or otherwise, Lessee may elect, within ( ) days after such condemnation or acquisition of title by such person or corporation, to give written notice to Lessor of its intention to terminate this lease as provided for in Article Fourteenth hereof, and as a part of said notice shall offer to purchase the leasehold estate under the Main Lease and the improvements located on the leased premises from Lessor upon the terms set out in Article Fourteenth hereof. In the event such offer to purchase is accepted by Lessor within the time and in the manner in Article Fourteenth provided, and said leasehold estate under the Main Lease and the improvements located on the leased premises are purchased by Lessee, Lessee shall be entitled to and shall receive any and all award or payment made in said condemnation proceedings, and Lessor shall assign, and Lessor does hereby assign and transfer to Lessee such award or payment as may be made. Should said offer to purchase not be accepted by Lessor and this lease be terminated as provided for in said article, any and all award or payment made in such condemnation proceedings in respect only of the buildings and improvements shall be paid to Lessor; provided, however, that Lessee shall be entitled to receive and retain any award or payment made in respect of the loss of, or damage to, Lessee's leasehold interest in this lease and in the Main Lease. Should Lessee, however, remain in possession and not elect to give such notice of termination of this lease, this lease shall be deemed to continue as to the remaining portion of the leased premises. In such event, Lessee shall be entitled to and shall receive any and all award or payment made in said condemnation proceedings, in respect to the

damage to Lessee's leasehold interest in this lease and in the Main Lease and also in respect to the damage to the buildings and improvements, and Lessor shall assign, and Lessor does hereby assign and transfer to Lessee such award or payment made in respect of damage to the buildings and improvements. With the proceeds of the award or payment so assigned to Lessee, Lessee shall make all repairs or alterations (if any) to the leased premises made necessary by such condemnation; should the cost of such repairs or alterations be less than the award or payment so assigned to Lessee, Lessee shall pay to Lessor the remaining balance of such award or payment, such remaining balance being hereinafter referred to as net surplus award. Following the making of the condemnation award or payment, and on completion of the repairs or alterations, if any, made by Lessee as herein provided, the monthly rental for the calendar month following the date on which the net surplus award is paid to Lessor, and the rental payments for each month thereafter during the original term hereof, shall be reduced in an amount equal to one-twelfth (1/12th) of
per centum (%) of the net surplus award, if any, paid by Lessee to Lessor as in this article provided. Should the entire leased premises be condemned at any time during the original term hereof and this lease terminated by operation of law rather than through the exercise of Lessee's option to terminate as hereinabove provided, then, and in such event, Lessee shall be entitled to the entire condemnation award and Lessee shall pay to Lessor an amount equivalent to the applicable purchase price determined in the manner provided in Article Fourteenth, as of the date of the termination of this lease.

Should the condemnation occur during a renewal option term, Lessee shall, within ( ) days after such condemnation, either (a) terminate the renewal term then in effect, or (b) remain in possession and repair the leased

premises. If Lessee elects to terminate the renewal term, Lessee shall give to Lessor ( ) days' notice, in writing, cancelling and terminating such renewal term. On expiration of said ( ) days' notice, the renewal term shall cease and determine. In such event, Lessee shall be entitled to receive and retain any award or payment made in respect of the loss of, or damage to, Lessee's leasehold interest in this lease and in the Main Lease and Lessor shall be entitled to receive and retain any award or payment made in respect of the buildings and improvements. Should Lessee, however, elect to remain in possession, the renewal term shall continue as to the remaining portion of the leased premises. In such event, Lessee shall be entitled to and shall receive any and all award or payment made in said condemnation proceedings, in respect to the damage to Lessee's leasehold interest in this lease and in the Main Lease and also in respect to the damage to the buildings and improvements, and Lessor shall assign, and Lessor does hereby assign and transfer to Lessee such award or payment made in respect of damage to the buildings and improvements. With the proceeds of the award or payment so assigned to Lessee, Lessee shall make all repairs or alterations (if any) to the leased premises made necessary by such condemnation; should the cost of such repairs or alterations be less than the award or payment so assigned to Lessee, Lessee shall pay to Lessor the remaining balance of such award or payment.

Anything in this Article Twelfth to the contrary notwithstanding, the right pursuant to this article of Lessee or Lessor to receive any award or payment made in a condemnation proceeding shall be subject to the rights of Landlord to receive said award or payment pursuant to Article of the Main Lease.

Article Thirteenth (Notices): Any notice provided for herein shall be given by registered United States mail, postage prepaid, addressed, if to Lessor, to the person to

whom the rent is then payable at the address to which the rent is then mailed, and, if to Lessee, to it at P.O. Box 660, Oakland 4, California. The person and the place to which notices are to be mailed may be changed from time to time by either party by written notice given to the other party.

Article Fourteenth (Lessee's right of termination): Lessor agrees that Lessee may, subject to the following conditions, at the option of Lessee, terminate this lease at any time during the original term hereof provided Lessee intends to cease grocery supermarket operations on the leases premises. In the event Lessee desires to exercise this option and to terminate this lease, it shall give written notice to Lessor of its intention to terminate this lease and as a part of such notice, shall offer to purchase Lessor's interest from Lessor for the applicable price computed in accordance with the schedule attached hereto and marked Exhibit "A", less the amount of any net surplus award or awards received by Lessor under the terms of Article Twelfth hereof.

In the event Lessor elects to accept said offer to purchase, Lessor shall, within ( ) days after the date of Lessee's notice to Lessor, deliver to Lessee written notice of such acceptance, and shall open or cause an escrow to be opened with a bank, trust company or title company, hereinafter referred to as escrow holder, and shall deposit in said escrow an instrument conveying, selling and assigning the Main Lease, and such other instruments and authorizations as may be necessary to convey to, and vest in Lessee such title to the Main Lease and the buildings and improvements upon the leased premises as that Lessee will upon the escrow completion be able to obtain from a title insurance company satisfactory to Lessee, a leasehold policy of title insurance in the amount of the purchase price paid by Lessee, insuring Lessee, or if title insurance

is not available, a title opinion written by an attorney designated by Lessee substantiating that it is the unencumbered owner of the Main Lease, free and clear of any mortgages or deeds of trust (which shall be released or reconveyed of record by Lessor in the escrow settlement) and free and clear of any other liens, charges, encumbrances or exceptions, except such as may have been in existence at the time of Lessor's acquisition of title to the Main Lease or as may have been created or suffered by Lessee. Lessor shall immediately notify Lessee of the opening of the escrow and Lessee shall, within ten (10) days after receipt of said notice and approval by Lessee of Lessor's title, deliver to said escrow holder, the purchase price, with instructions to deliver the same to Lessor when, upon recording the necessary instruments, it will be in a position to issue, or to obtain for Lessee, the leasehold policy of title insurance or attorney's opinion as hereinabove provided. In the event the title of Lessor is found to be imperfect or to be clouded so that title cannot be conveyed to Lessee as hereinabove provided, Lessor agrees to take proper proceedings to remove or correct any such defect so that title will vest in Lessee as herein provided for, such proceeding to be completed by not more than ( ) days after the date of Lessee's notice of termination and offer to purchase. If Lessee purchases the Main Lease as herein provided, Lessee shall pay rent to the date of its purchase of said Main Lease and Lessee shall also pay, for the account of Lessor, the amount of the prepayment penalty, if any, that Lessor may become obligated to pay in connection with the prepayment of any mortgages or deeds of trust to which the property may be subject, it being provided that such prepayment penalty shall not exceed the lesser of two per centum (2%) of the purchase price to be paid by Lessee as hereinabove provided or two per centum (2%) of the unpaid balance of any such mortgage or deed of trust; and Lessee shall also pay all charges covering the escrow fee, the recording fees,

the premium for a leashold policy of title insurance, the abstract continuation charge and the cost of the documentary internal revenue stamps and any applicable state or local taxes on transfers of interests in realty and other like charges. Lessee further agrees that if Lessee purchases the Main Lease as herein provided, Lessee shall cease grocery supermarket operations on the Leased premises within three (3) months after the date Lessee acquires title to the Main Lease.

Should written notice of the acceptance of Lessee's offer to purchase, signed by Lessor, not be received within ( ) days after the date of Lessee's notice to Lessor, or should Lessor, after having accepted Lessee's offer to purchase, be unable to convey title to the Main Lease to Lessee, as hereinbefore set out within the ( ) day time period herein limited, then, in either such event, this lease shall terminate and end at the expiration of ( ) days after the days of Lessee's notice of termination to Lessor. In the event of such termination as provided for herein, all parties hereto shall be discharged from further liability by reason of this lease and this lease shall be of no further force or effect. Lessee shall pay rent to the date of termination, and shall vacate and remove its property from the leased premises by such date of termination, and as of such date proper adjustment shall be made in respect of taxes and unexpired insurance premiums.

ARTICLE FIFTEENTH (Bankruptcy): Should Lessee file any petition or institute any proceedings under the Bankruptcy Act, as such Act now exists or under any amendment thereof which be enacted, or under any other Act or Acts, either as a bankrupt an insolvent, wherein or whereby Lessee seeks to be adjudicated a bankrupt or to be discharged from any or all of its debts, or to effect a plan of reorganization, or for any other similar relief, or if any such petition or pro-

ceedings of the same or similar kind or character be filled or taken against Lessee, or if any receiver for all or a substantial part of the business of Lessee shall be appointed by any court, and such petition or proceeding shall not be set aside or dismissed or the appointment of said receiver revoked within thirty (30) days, then, in any of such events, Lessor may, at Lessor's option, cancel and terminate this lease on the giving to Lessee of a thirty (30) days' notice in writing.

ARTICLE SIXTEENTH (Lessor's right of entry): Lessor reserves the right to enter upon the leased premises during business hours at any time to inspect the same or to make such repairs as Lessor may deem advisable (even though the same may not be required by this lease), or for the purpose of exhibiting the same to persons wishing to purchase the same. Lessor also reserves the right, at any time within thirty (30) days next preceding the expiration of the term hereby granted, or any renewal thereof, provided said term has not been extended by Lessee's exercise of th option privileges contained in Article Twentieth hereof, to place notices on the front of the leased premises, offering said leased premises "to let" or "for sale", and such notice or notices shall not be removed by Lessee, or Lessee's agents or employees. Such notices, however, shall not be placed upon the doors or windows of the building improvements.

ARTICLE SEVENTEENTH (Compliance with laws): Lessee agrees throughout the original term of this lease, or any renewal thereof, to comply with all laws, ordinances, orders, rules, regulations and requirements of all governmental authorities having jurisdiction of the leased premises. Lessee may contest the validity of any such laws, ordinances, orders, rules, regulations and requirements but shall indemnify and hold Lessor harmless against the consequences of any violation thereof by Lessee.

ARTICLE EIGHTEENTH (Lessor's remedies): No remedy herein conferred upon or reserved to Lessor or to Lessee is intended to be exclusive of any other remedy herein or by law provided, but each shall be cumulative and shall be in addition to every other remedy given hereunder or now or hereafter existing at law or in equity or by statute.

ARTICLE NINETEENTH (Article headings): The article headings herein contained are inserted only as a matter of convenience and for reference and in no way define, limit or describe the scope or intent of this lease nor in any way affect the terms and provisions hereof.

ARTICLE TWENTIETH (Lessee's option privileges):

less any net surplus award paid to Lessor under Article Twelfth hereof, and upon the terms (other than length of term and monthly rental) herein specified. These options shall be exercised by written notice given to Lessor or delivered or mailed to Lessor, at the address to which notice shall be sent as provided in Article Thirteenth, at least six (6) months before the expiration of the original term hereof, or, in the event Lessee has previously exercised one or more options herein given, such notice shall be given at least six (6) months before the expiration of the option term then in effect. The parties hereto agree that a new lease need not be executed upon the exercise of any of these options, but that this lease will remain in full force and effect, changed only as to the matters specified in this article, and except that Lessee may, on the giving to Lessor of a six (6) months' written notice, cancel any option term then in effect.

ARTICLE TWENTY-FIRST (Lessor's agreement to extend Main Lease): Lessor agrees that if upon the exercise by Lessee of any option herein provided, the term hereof as extended by the exercise of such option shall exceed the

original term of the Main Lease or the option term thereof then in effect, Lessor will promptly exercise the necessary option to extend the term of said Main Lease, and in the event Lessor fails to exercise such option, Lessee shall have the right to do so.

Article Twenty-Second (Covenants re termination Main Lease): Lessor covenants and agrees that it will not, prior to the expiration or sooner termination of the initial term hereof, or, in the event Lessee exercises the option or options to renew herein contained, prior to the expiration or sooner termination of said renewal term or terms, exercise any option or right to terminate said Main Lease without first obtaining the written consent of Lessee. If, however, Lessee is in default under the provisions of this lease and permits such default to continue in effect for thirty (30) days after receipt of notice thereof from Lessor in writing, then Lessor shall have the right to terminate said Main Lease without first obtaining the written consent of Lessee. Before exercising such right of termination, however, Lessor shall first deliver or mail to Lessee a thirty (30) days' written notice of Lessor's intention to terminate said Main Lease, providing in such notice that Lessee shall have an option during said thirty (30) day period to purchase from Lessor said Main Lease and the buildings and improvements on the leased premises for the price and upon the terms specified in Article Fourteenth hereof.

Article Twenty-Third (Lessor's indemnification of Lessee): Lessor covenants and agrees that in the event this lease is terminated during the original term thereof, and in the further event that upon said termination, Lessor rejects Lessee's offer to purchase the Main Lease, as referred to in Article Fourteenth hereof and does not convey the buildings and improvements and reassign the Main Lease to Lessee, then, and in such event, Lessor will thenceforth pay to Landlord all rentals that become due

and perform all of the obligations of the Tenant under the terms and provisions of said Main Lease, and Lessor will indemnify and hold Lessee harmless of and from any and all loss or damage that Lessee may suffer as a result of Lessor's breach of any of the covenants and agreements contained in said Main Lease to be performed by Tenant.

Lessee agrees that upon the termination of the original term of this lease by lapse of time, or, in the event Lessee exercises the option or options to renew herein contained, upon the expiration or sooner termination of said renewal term or terms, Lessor shall have the election upon notice to Lessee (1) to reassign the Main Lease to Lessee and convey the buildings and improvements then on the leased premises to Lessee, in which event Lessee shall accept the assignment and conveyance and thereafter Lessee shall perform and abide by the provisions of the Main Lease, including payment of all rent under said Main Lease, or (2) that Lessor may elect not to reassign the Main Lease and convey the buildings and improvements to Lessee, in which event thereafter Lessor shall pay the rent and perform all of the other obligations of the Main Lease and shall indemnify and hold Lessee harmless of and from any and all loss or damage that Lessee may suffer as a result of Lessor's breach of any of the covenants and agreements contained in said Main Lease to be performed by Tenant. Such election shall be made by Lessor at least ( ) days prior to the expiration by lapse of time of the original term of this lease, or at least ( ) days prior to the expiration of any renewal term either by lapse of time or by notice of termination. In the event no such notice of election is given to Lessee by Lessor, Lessor shall be deemed to have elected to reassign the Main Lease and to convey the buildings and improvements then on the leased premises to Lessee and shall proceed with due diligence to do so.

ARTICLE TWENTY-FOURTH (Rights of successors): Each and all of the covenants, terms, agreements and obligations of this lease shall extend to and bind and inure to the benefit of the heirs, the personal representatives, the successors and/or assigns of the lessor, and to the successors and/or assigns of the lessee; that herein the singular number includes the plural and the masculine gender includes the feminine and the neuter.

P. Ex. 49

SAFEWAY STORES, INCORPORATED

July 28, 1971

REGISTERED MAIL

Mr. T. H. Mayer and
Mr. Nicholas M. Mayer
c/o C. V. Barnes, Agent
P. O. Box 3546
Little Rock, Arkansas 72203

Re: Safeway Store # 182
NEC Markham St. & R. Parham Rd.
Little Rock, Arkansas

Gentlemen:

Safeway has determined to sell the building improvements placed upon the above premises leased from you pursuant to the terms of that certain Ground Lease dated May 1, 1968, and has received an acceptable, bona fide offer to purchase same from a third party. Under the terms of said Ground Lease, we are required to give you notice of our desire to sell the improvements and to offer same to you.

Accordingly, pursuant to Paragraph 15 of the Ground Lease dated May 1, 1968, Safeway hereby offers to sell the building improvements constructed on the above ground leased premises for a sales price of $235,000. The terms of the lease on the improvements would be twenty years running from the first day of the month following the date payment for the improvements is made to Safeway.

Rent during the original term would be in an amount sufficient to amortize the purchase price over the original term at a constant rate of 10.25%. This is equivalent to interest on the purchase price at the rate of approximately

8.28%. Rent during the option terms is based on 5% of the purchase price.

The lease which would be used would be our standard leasehold improvements lease, a copy of which is enclosed for your ready reference.

If you should accept this offer which is made pursuant to Paragraph 15 of the Ground Lease, this company would convey to you its interest in the building improvements on the ground leased premises and would enter into a lease on the terms above mentioned using the form of lease attached. The transaction should be completed within thirty days after your acceptance of this offer. The attached lease would be completed in the following manner:

a) By inserting appropriate reference to the Ground Lease in the preamble of the lease.

b) By inserting the legal description of the ground leased property in the space provided in Article First of the lease.

c) By providing the second paragraph of Article First for an original term of twenty years commencing the first day of the month next following the date payment of the purchase price is received by Safeway.

d) By providing in Article Second for a monthly rental during the original twenty year term for a monthly rental equal to 1/12th of 10.25% of the purchase price.

e) To insert 10.25% in the blank space in Article Twelfth toward the bottom of Page 6.

f) By providing in Article Twentieth for one option running from the dates of termination of the original twenty year term to April 30, 1993 and for five options of five years each at a monthly rental equal to 1/12th of 5% of the purchase price.

g) By attaching as an Exhibit "A" to the lease an amortization schedule which will provide for the amortization of the purchase price over the twenty year original term based on an annual constant rate of 10.25% with rental payments monthly.

You are advised that if you should determine to accept the above offer to purchase the building improvements made by Safeway on the ground leased premises in accordance with the terms outlined above, notice of your acceptance of such offer shall be delivered to this company at this office within thirty days from the date of this letter, otherwise the offer shall be of no further force or effect and your right of first refusal to purchase these building improvements under the terms of Paragraph 15 of the Ground Lease shall be terminated.

We shall appreciate hearing from you on the above matter at your early convenience.

Very truly yours,

/s/ JAMES B. BOLEN, JR.
James B. Bolen, Jr.
Attorney

This Lease, made the day of
19 , between
hereinafter referred to as lessor, and SAFEWAY STORES, INCORPORATED, a Maryland corporation, hereinafter referred to as lessee;

WITNESSETH: That in consideration of the mutual agreements herein contained, the parties hereto do hereby covenant to and with each other as follows:

Property Description

ARTICLE FIRST: Lessor does hereby lease to lessee the following described real property and the buildings and improvements thereon in the City of ,
County of , State of ,
designated as , to-wit:

Term

TO HAVE AND TO HOLD the above described premises, together with the tenements, hereditaments, appurtenances and easements thereunto belonging, at the rental and upon the terms and conditions herein stated, for an original term of years, commencing with the first day of , 19 , and extending to and including the last day of , 19 .

Rent

ARTICLE SECOND: Lessee does hereby agree to pay to lessor, as the rent of the leased premises, the sum of
dollars ($)
on the first day of each calendar month during said original term. Said payments shall be made by checks or drafts payable to ,
and mailed to at

or by checks or drafts made payable to any other payee or mailed to any other address which lessor, or any successor

in interest of lessor, may in writing designate. The rent for any fractional calendar month shall be prorated and paid on the first day of such fractional month.

Taxes, utility charges, etc.

ARTICLE THIRD: Lessee agrees that it will pay all charges for electricity, water, gas, telephone and other utility services used on the leased premises. Lessee further agrees to pay all taxes and assessments upon the leased premises which are payable during the original lease term or any renewal thereof. Taxes assessed during the term, but payable in whole or in installments after the termination of this lease, and assessments which are covered by bond, shall be adjusted and prorated and lessor shall pay the prorated share thereof for the period subsequent to the term, and lessee shall pay the prorated share thereof for the term of this lease.

Installation and removal of fixtures; painting, signs, etc.

ARTICLE FOURTH: Lessee may place or install on and/or in the leased premises such fixtures and equipment as it shall deem desirable for the conduct of business therein, and may paint the building improvements such colors as it elects. Lessee shall have the exclusive right to paint and erect or authorize signs in and over the leased premises and on the outside of the building improvements thereon. Personal property, fixtures and equipment used in the conduct of lessee's business (as distinguished from fixtures and equipment used in connection with the operation and maintenance of the building improvements) placed by lessee or any subtenant or any predecessor in interest on or in said premises (even though placed prior to the commencement of said term), shall not become a part of the realty, even if nailed or screwed or otherwise fastened to the premises, but shall retain their status as personalty and may be removed by lessee at any time. Lessee may obliterate any signs or color effects installed by it. Any damage caused the leased premises by the removal of such property shall be repaired by lessee at its expense.

Lessee's assumption of liability

ARTICLE FIFTH: Lessee agrees that it will indemnify and save lessor harmless from any and all liability, damage, expense, cause of action, suits, claims, or judgments arising from injury to person or property on the leased premises, or upon the adjoining streets and sidewalks, except such as may arise out of the willful or negligent act of lessor, or lessor's agents or employees.

Repairs, alterations, and improvements; state of repair on termination; future development and lessee's options with respect thereto

ARTICLE SIXTH: Lessee agrees that lessor shall be under no obligation to rebuild, replace, maintain or make any repairs to the leased premises, or to the improvements thereon during the lease term or any renewal thereof. Lessor agrees that lessee may make, or permit to be made, such alterations and improvements to the leased premises as lessee may deem desirable for the use thereof and may, at lessee's option and without cost to lessor, at any time and from time to time during the original lease term, or during any option period hereinafter provided for, do any one or more of the following:

I. Alter or remodel any building or improvements on the leased premises, provided the market value of any building or improvements so altered or remodeled is not adversely effected thereby, and/or

II. Construct an addition, or additions thereto, and/or

III. Raze any building or improvement situated on the leased premises and erect in the place thereof, a new building or improvement which shall be of a value not less than the market value of the building or improvement so razed at the time of its demolition.

At the expiration or termination of this lease, or any extension or renewal thereof, lessee shall leave the leased premises in good condition, allowance being made for ordinary wear and tear and damage by fire, or by earthquake, or by the elements, excepted, and lessee shall not be required to restore the leased premises to the condition in which the leased premises are in as of the commencement of the term hereof, it being agreed that lessor shall accept the leased premises with such alterations, remodeling, additions, or new construction, as may have been made pursuant to the authorization contained in this article. Lessee agrees that it will not permit any mechanic's, materialmen's or other liens to stand against the leased premises for work or materials furnished lessee in connection with any such alterations; remodeling, additions or new construction, it being provided, however, that lessee shall have the right to contest the validity of any such lien or claim, but upon a final determination of the validity thereof, lessee shall immediately pay any judgment or decree rendered against lessee, with all proper costs and charges, and shall cause any such lien to be released of record without cost to lessor.

Should lessee, during the original term hereof, alter, remodel, add to, or construct new improvements pursuant to the provisions of subparagraphs I, II or III hereof, and provided the cost thereof is Twenty-five Thousand and No/100 Dollars ($25,000.00), or more, lessee may, on completion of said improvements, offer to sell the same to lessor for an amount not greater than the cost thereof. Should lessor accept lessee's offer, which acceptance shall be made in writing within sixty (60) days of the date of such offer, lessor shall, within forty-five (45) days after lessor's written acceptance thereof, pay the purchase price to lessee and enter into a lease modification agreement covering the property hereby leased and such new improvements. The lease modification agreement shall (1) provide for the payment, during the balance of the original term, of additional rental at lessee's rental rate then in effect for sales of similar new properties, adjusted to reflect the difference in length of term; (2) increase the option rentals provided for in article Seventeenth hereof by an amount equal to one-twelfth (1/12th) of the purchase price of such new improvements multiplied by the

rental rate then being paid by lessee as rental during option terms; and (3) increase the purchase price provided for in article Fourteenth hereof by an amount equal to the unamortized portion of said purchase price of such new improvements at the time of lease termination. Should lessee's offer to sell such new improvements and be accepted by lessor within said sixty (60) day period, lessee shall have the option of permitting this lease to continue in effect without any modification or change whatsoever or, in the alternative, lessee may, at any time within six (6) months after the date of lessee's offer to sell said new improvements, require lessor to sell the leased premises, including the new improvements erected thereon, to lessee in the manner, and upon the terms as set forth in article Fourteenth hereof, except, however, for the provision in said article which permits lessor to terminate this lease and refuse to sell the leased premises and the provision whereby lessee agrees to cease grocery supermarket operations on the leased premises within three (3) months after acquiring title, both of which provisions shall be wholly inoperative.

Assigning and subletting

ARTICLE SEVENTH: Lessee shall have the right to assign or transfer this lease or to underlease or sublet the whole or any part of said leased premises. Should lessee assign this lease it shall nevertheless remain liable to lessor for full payment of the rent and lessee's other obligations under this lease.

Holding over

ARTICLE EIGHTH: If lessee holds over or remains in possession of the leased premises after expiration of this lease or after any sooner termination thereof, without any new lease of said premises being entered into between the parties hereto, or any option hereinafter contained being

exercised by written notice, such holding over or continued possession shall, if rent is paid by lessee, and accepted by lessor for or during any period of time lessee holds over or remains in possession, create a tenancy from month to month only at the last monthly rental and upon the terms (other than length of term, or option for renewal, purchase or cancellation) herein specified, which may at any time be terminated by either party by thirty (30) days' written notice given to the other party.

Quiet possession

ARTICLE NINTH: Lessor covenants that lessor is seized of the leased premises and has full right to make this lease, and that so long as lessor is the owner of the leased premises, lessee shall have quiet and peaceful possession thereof as against any adverse claim of lessor or any party claiming under lessor.

Lessee's default; lessor's default

ARTICLE TENTH: In case lessee shall default in the performance of any covenant or agreement herein contained, and such default shall continue for thirty (30) days after receipt by lessee of written notice thereof given by lessor, or the agent or attorney of lessor, then lessor, at the option of lessor, may declare said term ended, and may reenter upon the leased premises either with or without process of law, and remove all persons therefrom. Lessee expressly agrees that the exercise by lessor of the right of re-entry shall not be a bar to or prejudice in any way any other legal remedies available to lessor. In case lessor shall default in the performance of any covenant or agreement herein contained, and such default shall continue for thirty (30) days after receipt by lessor of written notice thereof given by lessee, its agent or attorney, then no rent shall be paid or become payable under this lease for such time as such default shall continue after the expiration of said thirty (30) days' period and lessee, at its option, may

(1) declare the term ended and vacate the leased premises and be relieved from all further obligations under this lease, or (2) pay any sum necessary to perform any obligation of lessor hereunder, and deduct the cost thereof, with interest, from the rents thereafter to become due hereunder. The performance of each and every agreement herein contained on the part of lessor shall be a condition precedent to the right of lessor to collect rent hereunder or to enforce this lease as against lessee.

Damage by fire, etc.

ARTICLE ELEVENTH: Lessee agrees that it will, during the original term hereof, or any renewal thereof, at its expense, keep in effect upon the leased premises, fire insurance with extended coverage endorsement, written by a responsible insurance company or insurance companies authorized to do an insurance business in the state in which the leased premises are located, in an amount equal to not less than eighty per centum (80%) of the insurable value of the building improvements thereon, said policy or policies of insurance to provide that payment for any losses covered under or by said policy or policies of insurance shall be made to lessor and/or lessee and/or any mortgagee and/or assignee designated by lessor from time to time, as their respective interests may appear. Lessor agrees that in the event of loss of or damage to said building improvements by fire or other casualty during the original term or any renewal thereof, lessee may, at its option, rebuild or repair said building improvements, in which event all insurance proceeds shall be paid by said insurance company or companies to and retained by lessee. Should the fire or other casualty occur during the original term and lessee elect not to rebuild or repair said building improvements, lessee shall, within ninety (90) days after such loss or damage, give written notice to lessor of lessee's intention to terminate this lease as provided for

in article Fourteenth hereof, and as a part of said notice shall offer to purchase the leased premises upon the terms set out in said article. In the event said offer to purchase is accepted by lessor and said property purchased by lessee, all insurance proceeds shall be paid by said insurance company or companies to and retained by lessee. However, should said offer to purchase not be accepted by lessor and this lease be terminated as in said article provided, lessee shall be deemed to and does hereby agree to relinquish all rights to the proceeds of any insurance in effect upon said building improvements and such proceeds shall be paid directly to lessor by said insurance company or companies. Notwithstanding the foregoing, in the event any mortgagee requires that the proceeds be made payable to it, then and in such event the proceeds shall be so paid to such mortgagee upon condition that said mortgagee shall agree to pay the said proceeds to lessee upon the restoration of the leased premises as in this article provided or upon the purchase of the leased premises by lessee as provided for in article Fourteenth hereof.

Should the fire or other casualty occur during a renewal option term and lessee elect not to rebuild or repair said building improvements, lessee shall, within ninety (90) days after such loss or damage give to lessor a thirty (30) days' notice, in writing, cancelling and terminating the renewal term then in effect. On expiration of said thirty (30) days' notice, the renewal term shall cease and determine and all insurance proceeds shall be paid directly to lessor by said insurance company or companies.

Condemnation

ARTICLE TWELFTH: In the event that any person or corporation, municipal, public, private or otherwise, shall at any time during the original term hereof condemn and acquire title to the leased premises, or any portion thereof, or to any easement therein, in or by condemnation pro-

ceedings pursuant to any law, general, special or otherwise, lessee may elect within thirty (30) days after such condemnation or acquisite of title by such person or corporation, to give written notice to lessor of its intention to terminate this lease as provided for in article Fourteen hereof, and as a part of said notice shall offer to purchase the leased premises from less or upon the terms set out in article Fourteenth hereof. In the event such offer to purchase is accepted by lessor within the time and in the m manner in article Fourteenth provided, and said leased premises are purchased by lessee, lessee shall be entitled to and shall receive any and all award or payment made in said condemnation proceedings, and Lessor shall assign, and lessor does hereby assign and transfer to lessee such award or payment as may be made. Should said offer to purchase not be accepted by lessor and this lease be terminated as provided for in said article, any and all award or payment made in such condemnation proceedings in respect only of the leased premises shall be paid to lessor; provided, however, that lessee shall be entitled to receive and retain any award or payment made in respect of the loss of, or damag to, lessee's leasehold interest. Should lessee, however, remain in posssion and not let to give such notice of termination of this lease, this lease shall be deemed to continue as to the remaining portion of the leased premises. In such event, lessee shall be entitled to and shall receive any and all award or payment made in said condemnation proceedings, in respect to the damage to Lessee's leasehold interest and also in respect to the damage to the leased premises, and lessor shall assign, and lessor does hereby assign and transfer to lessee such award or payment made in respect of damage to the leased premises. With the proceeds of the award or payment so assigned to lessee, lessee shall made all repairs or alterations (if any) to the leased premises made necessary by such condemnation, should the cost of such repairs or alterations be less than the award or payment so assigned to lessee,

lessee shall pay to Lessor the remaining balance of such award or payment, such remaining balance being hereinafter referred to as net surplus award. Following the making of the condemnation award or payment, and on completion of the repairs or alternations, if any, made by lessee as herein provided, the monthly rental for the calendar month following the date on which the net surplus award is paid to lessor, and the rental payments for each month thereafter during the original term hereof, shall be reduced in an amount equal to one-twelfth (1/12th) of per centum (%) of the net surplus award, if any, paid by lessee to lessor as in this article provided. Should the entire leased premises be condemned at any time during the original term hereof and this lease terminated by operation of law rather than through the exercise of lessee's option to terminate as hereinabove provided, then, and in such event, lesse shall be entitled to the entire condemnation award and lessee shall pay to lessor an amount equivalent to the applicable purchase price determined in the manner provided in article Fourteenth, as of the date of the termination of this lease.

Should the condemnation occur during a renewal option term, lessee shall, within thirty (30) days after such condemnation, either (a) terminate the renewal term then in effect, or (b) remain in possession and repair the leased premises. If lessee elects to terminate the renewal term, lessee shall give to lessor thirty (30) days' notice, in writing, cancelling and terminating such renewal term. On expiration of said thirty (30) days' notice the renewal term shall cease and determine. In such event, lessee shall be entitled to receive and retain any award or payment made in respect of the loss of, or damage to, lessee's leasehold interest and lessor shall be entitled to receive and retain any award or payment made in respect of the leased premises. Should lessee, however, elect to remain in possession, the renewal term shall continue as to the

remaining portion of the leased premises. In such event, lessee shall be entitled to and shall receive any and all award or payment made in said condemnation proceedings, in respect to the damage to lessee's leasehold interest and also in respect to the damage to the leased premises, and lessor shall assign, and lessor does hereby assign and transfer to lessee such award or payment made in respect of damage to the leased premises. With the proceeds of the award or payment so assigned to lessee, lessee shall make all repairs or alterations (if any) to the leased premises made necessary by such condemnation; should the cost of such repairs or alterations be less than the award or payment so assigned to lessee, lessee shall pay to lessor the remaining balance of such award or payment.

Notices

ARTICLE THIRTEENTH: Any notice provided for herein shall be given by registered United States mail, postage prepaid, addressed, if to lessor, to the person to whom the rent is then payable at the address to which the rent is then mailed, and, if to lessee, to it at P.O. Box 660, Oakland 4, California. The person and the place to which notice are to be mailed may be changed from time to time by either party by written notice given to the other party.

Lessee's right of termination

ARTICLE FOURTEENTH: Lessor agrees that lessee may, subject to the following conditions, at the option of lessee, terminate this lease at any time during the original term hereof provided lessee intends to cease grocery supermarket operations on the leased premises. In the event lessee desires to exercise this option and to terminate this lease, it shall give written notice to lessor of its intention to terminate this lease and as a part of such notice, shall offer to purchase the leased premises from lessor for the applicable price computed in accordance with the schedule attached hereto and marked Exhibit "A", less the amount of any net surplus award or awards received by lessor under the terms of article Twelfth hereof.

In the event lessor elects to accept said offer to purchase, lessor shall within sixty (60) days after the date of lessee's notice to lessor, deliver to lessee written notice of such acceptance, and shall open or cause an escrow to be opened with a bank, trust company or title company, hereinafter referred to as escrow holder, and shall deposit and such title to the leased premises as that lessee will in said escrow a properly executed grant or warranty deed, upon the escrow completion be able to obtain from a title insurance company satisfactory to lessee, an owner's policy of title insurance in the amount of the purchase price paid by lessee, insuring lessee, or if title insurance is not available, a title opinion written by an attorney designated by lessee substantiating that it is the unencumbered fee title owner of the leased premises, free and clear of any mortgages or deeds of trust (which shall be released or reconveyed of record by lessor in the escrow settlement) and free and clear of any other liens, charges, encumbrances or exceptions, except such as may have been in existence at the time of lessor's acquisition of title to the leased premises or as may have been created or suffered by lessee. Lessor shall immediately notify lessee of the opening of the escrow and lessee shall, within ten (10) days after receipt of said notice and approval by lessee of lessor's title, deliver to said escrow holder, the purchase price, with instructions to deliver the same to lessor when, upon recording the deed, it will be in a position to issue, or to obtain for lessee, the owner's policy of title insurance or attorney's opinion as hereinabove provided. In the event the title of lessor is found to be imperfect or to be clouded so that title cannot be conveyed to lessee as hereinabove provided, lessor agrees to take proper proceedings to remove or correct any such defect so that title will vest in lessee as herein provided for such

proceeding to be completed by not more than seventy-five (75) days after the date of lessee's notice of termination and offer to purchase. If lessee purchases the leased premises as herein provided, lessee shall pay rent to the date of its purchase of said property and lessee shall also pay, for the account of lessor, the amount of the prepayment penalty, if any, that lessor may become obligated to pay in connection with the prepayment of any mortgages or deeds of trust to which the property may be subject, it being provided that such prepayment penalty shall not exceed the lessor of two per centum (2%) of the purchase price to be paid by lessee to lessor as hereinabove provided or two percentum (2%) of the unpaid balance of any such mortgage or deed of trust; and lessee shall also pay all charges covering the escrow fee, the recording fees, the premium for an owner's policy of title insurance, the abstract continuation charge, and the cost of the documentary internal revenue stamps and any applicable state tax stamps and other like charges. Lessee further agrees that if lessee purchases the leased premises as herein provided, lessee shall cease grocery supermarket operations on the leased premises within three (3) months after the date lessee acquires title to the leased premises.

Should written notice of the acceptance of lessee's offer to purchase, signed by lessor, not be received by lessee within sixty (60) days after the date of lessee's notice to lessor, or should lessor, after having accepted lessee's offer to purchase, be unable to convey title to the leased premises to lessee, as hereinbefore set out within the seventy-five (75) day time period herein limited, then in either such event this lease shall terminate and end at the expiration of ninety (90) days after the date of lessee's notice of termination to lessor. In the event of such termination as provided for herein, all parties here shall be discharged from further liability by reason of this lease and this lease shall be of no further force or effect. Lessee

shall pay rent to the date of termination, and shall vacate and remove its property from the leased premises by such date of termination, and as of such date proper adjustment shall be made in respect of taxes and unexpired insurance premiums.

Bankruptcy

ARTICLE FIFTEENTH: Should lessee file any petition or institute any proceedings under the Bankruptcy Act, either as such Act now exists or under any amendment thereof which may hereafter be enacted, or under any other Act or Acts, either as a bankrupt or as an insolvent, wherein or whereby lessee seeks to be adjudicated a bankrupt or to be discharged from any or all of its debts, or to effect a plan of reorganization, or for any other similar relief, or if any such petition or proceedings of the same or similar kind or character be filed or taken against lessee, or if any receiver for all or a substantial part of the business of lessee shall be appointed by any court, and such petition or proceeding shall not bet set aside or dismissed or the appointment of said receiver revoked within thirty (30) days, then, in any of such events, lessor may, at lessor's option, cancel and terminate this lease on the giving to lessee of a thirty (30) days' notice in writing.

Lessor's right of entry

ARTICLE SIXTEENTH: Lessor reserves the right to enter upon the leased premises during business hours at any time to inspect the same or to make such repairs as lessor may deem advisable (even though the same may not be required by this lease), or for the purpose of exhibiting the same to persons wishing to purchase the same. Lessor also reserves the right, at any time within thirty (30) days next preceding the expiration of the term hereby granted or any renewal thereof, provided said term has not been extended by lessee's exercise of the option privileges contained in article Seventeenth hereof, to place

notices on the front of the leased premises offering said leased premises "to let" or "for sale", and such notice or notices shall not be removed by lessee, or lessees agents or employees. Such notices, however, shall not be placed upon the doors or windows of the building improvements.

Lessee's option privileges

ARTICLE SEVENTEENTH: Lessor hereby grants to lessee, the right, at lessee's option, to extend the term of this lease for separate and additional periods of years each after the expiration of the term hereof at an annual rental payable in equal installments, equivalent to per centum (%) of dollars ($) less any net surplus award paid to lessor under article Twelfth hereof, and upon the terms (other than length of term and monthly rental) herein specified. These options shall be exercised by written notice given to lessor or delivered or mailed to lessor, at the address at which the rent is then payable, at least sixty (60) days before the expiration of the original term hereof, or, in the event lessee has previously exercised one or more options herein given, such notice shall be given at lease sixty (60) days before the expiration of the option term then in effect. The parties hereto agree that a new lease need not be executed upon the exercise of any of these options, but that this lease will remain in full force and article, and except that lessee may, on the giving to lessor effect, changed only as to the matters specified in this of a six (6) months written notice, cancel any option term then in effect.

Undeveloped parcel

ARTICLE EIGHTEENTH: Lessor agrees that lessee may improve and develop all or any part of Parcel II (hereinafter in this article referred to as Undeveloped Parcel)

of the real property herein described as an additional customers' parking lot at any time that lessee determines that such development is necessary or described in connection with lessee's operations on the leased premises. In the event lessee so improves and develops said Undeveloped Parcel, it shall, upon completion of said improvements, offer to sell the same to lessor for an amount not greater than the cost thereof to lessee. Should lessor accept lessee's offer, which acceptance shall be made in writing within sixty (60) days after the date of such offer, lessor shall, within forty-five (45) days after lessor's written acceptance thereof, pay the purchase price to lessee and enter into a lease modification agreement with lessee which shall (1) provide for an increase in the monthly rental under article Second hereof in an amount sufficient to fully amortize the purchase price of such improvements during the unexpired balance of the original lease term with interest at the rate of per centum (%) per annum; (2) increase the monthly installments of option rental under article Seventeenth hereof in an amount equal to one-twelfth (1/12th) of per centum (%) of said purchase price; and (3) increase the purchase price provided for in article Fourteenth hereof by an amount equal to the unamortized portion of the purchase price of such improvements at the time of lease termination.

Should lessor fail to accept lessee's offer to sell or to complete purchase of said improvements in the manner and within the time hereinabove provided, lessee shall have the right at any time thereafter during the original term of this lease to purchase said Undeveloped Parcel.

Lessor also agrees that if lessee at any time determines that it will not be necessary or desirable to improve and develop said Undeveloped Parcel as an additional customers' parking lot, then lessee shall have the right to purchase said Undeveloped Parcel, and further agrees

that if lessee at any time determines that it will be necessary and desirable to improve and develop only a portion of said Undeveloped Parcel as an additional customers' parking lot, then lessee shall have the right to purchase that portion of said Undeveloped Parcel that it determines not to improve and develop as an additional customers' parking lot.

Lessee agrees that if lessee has not improved and developed said Undeveloped Parcel, or any portion therof, as an additional customers' parking lot by the expiration of the first ten (10) years of the lease term, then lessee will, upon the written request of lessor, purchase said Undeveloped Parcel as an additional customers' parking lot by the expiration of the first ten (10) years of said lease term, then lessee will, upon the written request of lessor, purchase that portion of said Undeveloped Parcel that has not been improved and developed as an additional customers' parking lot.

In the event of a purchase by lessee of said Undeveloped Parcel, or any portion thereof, under the provisions of this article, the purchase shall be handled through an escrow and title shall be conveyed as provided in article Fourteenth hereof, the purchase price to be paid by lessee to lessor shall be an amount computed by multiplying the square foot area of the property so purchased by the sum of dollars ($), and the parties hereto shall enter a lease modification agreement which shall (1) exclude the property so purchased from the provisions of this lease; (2) decrease the monthly rental under article Second hereof by an amount equal to one-twelfth (1/12th) of per centum (%) of the purchase price paid by lessee to lessor; (3) decrease the monthly installments of option rental under article Seventeenth hereof by an amount equal to one-twelfth (1/12th) of per centum (%) of said purchase price paid by lessee to lessor; and (4) decrease the "Original Sale Price" specified in the schedule attached hereto and marked Exhibit "A" by the amount of said purchase price paid by lessee to lessor. Lessor in the deed by which lessor conveys said property to lessee may reserve easements and rights of way for all existing utilities that cross the parcel conveyed by lessor for the purpose of serving the balance of the leased premises retained by lessor, and shall convey to lessee all reasonable easements and rights of way for utility lines and other purposes across the portion of the leased premises retained by lessor that may be reasonably necessary to the development of the property conveyed to lessee.

Compliance with laws

ARTICLE NINETEENTH: Lessee agrees throughout the original term of this lease or any renewal thereof to comply with all laws, ordinances, orders, rules regulations and requirements of all governmental authorities having jurisdiction of the leased premises. Lessee may contest the validity of any such laws, ordinances, orders, rules, regulations and requirements but shall indemnify and hold lessor harmless against the consequences of any violation thereof by lessee.

Lessor's remedies

ARTICLE TWENTIETH: No remedy herein conferred upon or reserved to lessor or to lessee is intended to be exclusive of any other remedy herein or by law provided, but each shall be cumulative and shall be in addition to every other remedy given hereunder or now or hereafter existing at law or in equity or by statute.

Marginal notes

ARTICLE TWENTY-FIRST: The marginal notes herein contained are inserted only as a matter of convenience and for reference and in no way define, limit, or describe the scope or intent of this lease nor in any way affect the terms and provisions hereof.

Exhibit "A"

Column One: Number of Months Elapsed Since Beginning of Lease Term.

Column Two: Purchase Price For Each $10,000.00 of Original Sale Price.

Original Sale Price $

One	Two	One	Two	One	Two	One	Two
1	9981	61	8634	121	6700	181	3924
2	9963	62	8607	122	6662	182	3869
3	9944	63	8580	123	6623	183	3814
4	9925	64	8553	124	6584	184	3758
5	9906	65	8526	125	6545	185	3701
6	9887	66	8498	126	6505	186	3645
7	9868	67	8471	127	6466	187	3588
8	9848	68	8443	128	6426	188	3530
9	9829	69	8415	129	6385	189	3473
10	9809	70	8387	130	6345	190	3415
11	9789	71	8358	131	6304	191	3356
12	9769	72	8330	132	6263	192	3298
13	9749	73	8301	133	6222	193	3239
14	9729	74	8272	134	6181	194	3179
15	9709	75	8243	135	6139	195	3119
16	9689	76	8214	136	6097	196	3059
17	9668	77	8185	137	6055	197	2999
18	9648	78	8155	138	6013	198	2938
19	9627	79	8125	139	5970	199	2876
20	9606	80	8096	140	5927	200	2815
21	9585	81	8065	141	5884	201	2753
22	9564	82	8035	142	5841	202	2691
23	9543	83	8005	143	5797	203	2628
24	9522	84	7974	144	5753	204	2565
25	9500	85	7943	145	5709	205	2501
26	9478	86	7912	146	5664	206	2437
27	9457	87	7881	147	5619	207	2373

28	9435	88	7850	148	5574	208	2308
29	9413	89	7818	149	5529	209	2243
30	9391	90	7786	150	5483	210	2178
31	9368	91	7754	151	5437	211	2112
32	9346	92	7722	152	5391	212	2046
33	9324	93	7690	153	5345	213	1979
34	9301	94	7657	154	5298	214	1912
35	9278	95	7625	155	5251	215	1845
36	9255	96	7592	156	5204	216	1777
37	9232	97	7558	157	5156	217	1708
38	9209	98	7525	158	5108	218	1640
39	9185	99	7492	159	5060	219	1571
40	9162	100	7458	160	5012	220	1501
41	9138	101	7424	161	4963	221	1431
42	9114	102	7390	162	4914	222	1361
43	9091	103	7355	163	4865	223	1290
44	9066	104	7321	164	4815	224	1219
45	9042	105	7286	165	4765	225	1147
46	9018	106	7251	166	4715	226	1075
47	8993	107	7216	167	4665	227	1003
48	8969	108	7180	168	4614	228	930
49	8944	109	7145	169	4563	229	856
50	8919	110	7109	170	4511	230	783
51	8894	111	7073	171	4459	231	708
52	8869	112	7037	172	4407	232	634
53	8843	113	7000	173	4355	233	558
54	8818	114	6964	174	4302	234	483
55	8792	115	6927	175	4249	235	407
56	8766	116	6889	176	4196	236	330
57	8740	117	6852	177	4142	237	253
58	8714	118	6814	178	4088	238	176
59	8687	119	6777	179	4034	239	98
60	8661	120	6739	180	3979	240	0

20 Yr. 7¼%

P. Ex. 50

FRANK LYON COMPANY

April 12, 1968

Mr. Ed Penick, President
Worthen Bank & Trust Company
4th & Main Streets
Little Rock, Arkansas 72201

Dear Ed:

I understand and am in complete sympathy with your desire to have some person or corporation own the Worthen building that is acceptable to you.

Accordingly, before I, my immediate heirs, and my current working associates would ever sell Frank Lyon Company or lose control of Frank Lyon Company, I will contact you to see that the bank's interest, in having an acceptable owner of the building, is protected and will at that time sell the building to you or your nominee at a price which we will negotiate.

These transactions will be subject to your approval provided that your approval will not be unreasonably withheld.

Yours truly,

FRANK LYON COMPANY

/s/ FRANK LYON
Frank Lyon
Chairman of the Board

P. Ex. 51

CABOT, CABOT & FORBES EQUITY TRUST

April 26, 1974

Mr. Frank Lyon
Chairman of the Board
Frank Lyon Company
West 65th Street and Scott Hamilton Drive
Little Rock, Arkansas

Dear Mr. Lyon:

This past week my associates and I had an opportunity to visit Little Rock. We were particularly impressed by the Worthen Bank Building and learned, with interest, that you are the owner of this property. This letter is to introduce ourselves and to inquire if there may be some interest on your part in selling this property.

Cabot, Cabot & Forbes Equity Trust is a recently established real estate investment trust privately held at this time. (Cabot, Cabot & Forbes Land Trust, a sister company, is traded on the New York Stock Exchange.) The Equity Trust invests primarily in substantial and seasoned "landmark" properties, i.e. properties which have a preferred address within a local market due to excellence of design and high quality of tenancy.

The Equity Trust has great flexibility in structuring to investments and can purchase a variety of interests in a property, including a partial interest, a partnership position, or corporate stock. Payment can be structured for tax and other advantages to include a tax free exchange of stock, the issuance of convertible debt, as well as cash. Existing property management agreements can be continued or the Equity Trust can itself provide such management.

We believe the building is truly a fine property and the association of the Worthen Bank with the building a valuable one. In this type of transaction we would essentially be passive investors and in no way attempt to change the "identity" of the building or alter the existing arrangements between landlord and tenant.

It is interesting to note that another sister company, Cabot, Cabot & Forbes, owns and manages a number of high rise office structures throughout the country. Many of these have as their major tenants a bank, and usually the building has been named after the bank. Thus we are experienced in owning and managing bank related properties and are sensitive to the needs and requirements of tenants in these properties.

I hope this brief letter gives you an insight into our organization. I would appreciate the opportunity of exploring this in greater detail and am looking forward to hearing from you.

Very truly yours,

/s/ RUDY LANDRY
Rudy Landry
Investment Officer

P. Ex. 52

EXPLANATION OF ITEMS

FORM 886-A
SNAPOUT
FEBRUARY 1969

SCHEDULE NO. OR EXHIBIT

NAME OF TAXPAYER
Frank Lyon Company

YEAR/PERIOD ENDED
1969-1970

(b) Net Adjustments

Worthen Accounts	1969	$497,219.18
	1970	538,325.05

Summary of Income and Expense Accounts adjusted as follows:

	1969	1970
(1) Rental Income	$(48,527.01)	$(582,324.12)
(2) Interest Expense (1 mo with NYL, accrued)	40,162.50	478,801.53
(3) Depreciation	51,618.79	614,269.78
(4) Interest, Legal, Audit, etc., during construction	451,666.75	
(5) Interest Income	2,298.15	27,577.86
Totals, as above	$497,219.18	$ 538,325.05

Explanation—

(1), (2), (3), (4)—It has been determined based on the facts and circumstances that you are not the owner for tax purposes of any portion of the Worthen Building. Therefore, the income and expenses related to this building are not allowable to you for Federal income tax purposes.

(5)—You invested $500,000 in the Worthen Building, which transaction is considered to be a loan rather than an investment, since as stated above, the Worthen Building has been determined not to be your property. Computation of accrued interest is as follows:

Option price of Worthen Building, 11-30-80	$6,325,169.85
Loan Balance to New York Life Insurance, 11-30-80	5,521,813.36
Balance	$ 803,356.49
Cost	500,000.00
Gain	$ 303,356.49

This gain of $303,356.49 is considered the equivalent of interest income to be accrued over the (11) eleven-year period of the lease to the option date 11-30-80.

1969 Interest—303,356.49 ÷ 11 ÷ 1/12 = $2,298.15
1970 Interest—303,356.49 ÷ 11 = $27,577.86

D. Ex. 1

WORTHEN BANK & TRUST CO.

1969 Exhibit

EQUITY INTEREST IN LAND AND BUILDINGS

Land			$1,439,843.70
Parking deck			1,194,260.47
Office and bank building		$9,642,932.18	
Less sales proceeds from Frank Lyon Co.:			
N.Y. Life Ins. Co. (loan)	$7,140,000		
Lyon investment	500,000	7,640,000.00	2,002,932.18
Total cost (equity) to Worthen Bank and Trust Co. as of Dec. 1, 1969			$4,637,036.35

Equity and percentages:	Cost	%
Frank Lyon Co.	$ 7,640.000.00	62.23
Worthen Bank and Trust Co.	4,637,036.35	37.77
Totals	$12,277,036.35	100.00

D. Ex. 2

FRANK LYON CO. — WORTHEN BUILDING

CASH FLOW

Year		Rent Income	Loan Payments (Prin. & Int.)	Balance (Cash flow)
1969	1 mo	48,527.01	48,527.01	- 0 -
1970		582,324.12	582,324.12	
1971		"	"	"
1972		"	"	"
1973		"	"	"
1974		"	"	"
1975		"	"	"
1976		"	"	"
1977		"	"	"
1978		"	"	"
1979		"	"	"
1980	11 mo	533,797.11	533,797.11	- 0 -

TAX — CASH FLOW

3,458,174.85 × 25% = (864,543.71)
3,154,819.11 × 48% = 1,514,313.17

649,769.46

D. Ex. 3

FRANK LYON CO. — WORTHEN BUILDING
LOSS FROM RENTAL OPERATION

Year		Rental Income	Interest Exp. (Pd. on Building Note)	Other Exp. (Interim Financing)	Depr. (Accelerated Basis)
1969	1 mo	48,527.01	40,162.50	451,666.75	51,618.79
1970		582,324.12	478,801.52		614,271
1971		582,324.12	471,634.87		552,977
1972		582,324.12	463,971.97		498,575
1973		582,324.12	455,778.93		450,229
1974		582,324.12	447,018.36		407,202
1975		582,324.12	437,651.43		368,861
1976		582,324.12	427,636.04		334,641
1977		582,324.12	416,927.31		304,063
1978		582,324.12	405,547.24		276,693
1979		582,324.12	393,234.49		252,160
1980	11 mo	533,797.11	349,084.02		210,045
Totals		6,405,565.32	4,787,378.68	451,666.75	4,321,339.79

Overall Results—11 yr. period

Rent Income		6,405,565.32
Less:		
Interest Expense	4,787,378.68	
Other Expense—Interim Financing	451,666.75	
Depreciation—Accelerated Basis	4,321,339.00	
		9,560,384.43
RENTAL LOSS		3,154,819.41

D. Ex. 4

FRANK LYON CO. — WORTHEN BUILDING

GAIN ON SALE 1980

If 1980 Option Is Exercised

Sales Price 11-30-80	6,325,169.85
Less—Basis of Building After Accelerated Depn. 11-30-80	2,866,995
Gain (Long Term)	3,458,174.85

D. Ex. 5

FRANK LYON CO. — WORTHEN BUILDING

TAX CONSEQUENCE VS. ECONOMIC GAIN

If 1980 Option Is Exercised

Tax Consequence		
Gain on Sale—Taxed as Long Term Capital Gain— Total Gain	3,458,174.85	
Less 50% Nontaxable (Sec. 1202 Deduction)	1,729,087.43	
Taxable Portion of Long Term Capital Gain		1,729,087.42
Rental Loss— Ordinary Deduction (11 yr.)		3,154,219.11
Difference—Net Tax Deduction		(1,425,731.69)
Economic Gain		
Gain on Sale of Building Back to Worthen	3,458,174.85	
Loss on Rental Operation	3,154,819.11	
Economic Gaain		303,355.74

D. Ex. 6

FRANK LYON CO. — WORTHEN BUILDING

TAX BENEFIT—IF OPTION EXERCISED NOV. 30, 1980

Taking 1969 Tax Reform Act Into Account

Cash position after 11 yr.:

Direct:				
Gain on sale			3,458,174.85	
Loss on rents			3,154,819.11	303,355.74
Tax benefit:				
Sec. 1250				
SL dep'n				
2,444,033.32	15 yr	162,935.55		
1,365,783.30	40 yr	34,144.58		
3,378,516.63	30 yr	112,617.22		
Dep'n per yr		309,697.35		
× 11 yr		3,406,670.85		
Accl. dep'n claimed		4,321,339		
Excess dep'n—				
Ordinary income		914,668.15		
Rent losses	@ 48%	3,154,819.11	1,514,313.17	
Sec. 1250 gain		(914,668.15)	(439,040.71)	
Gain on sale		3,458,174.85		
Less Sec. 1250 gain		914,668.15		
Net long-term cap. gn. @ 30%		(2,543,506.70)	(763,052.01)	
Net FIT benefit				312,220.45
Total cash benefit (cash flow)				615,576.19

D. Ex. 7

FRANK LYON COMPANY
LOAN FROM NEW YORK LIFE
(Schedule 12/16/69)

SCHEDULE OF DIRECT REDUCTION LOAN

Rate %	Payment $	Loan $
6.750	153,289.32	7140,000.00
Term: Years	Months	Periods

Prepared by Financial Publishing Company, Boston

Payment Number	Net Interest	Principal Payment	Balance of Loan
1	120,487.50	25,093.53	7114,906.47
2	120,064.05	25,516.98	7089,389.49
3	119,633.45	25,947.58	7063,441.91
4	119,195.58	26,385.45	7037,056.46
5	118,750.33	26,830.70	7010,225.76
6	118,297.56	27,283.47	6982,942.29
7	117,837.15	27,743.88	6955,198.41
8	117,368.97	28,212.06	6926,986.35
9	116,892.89	28,688.14	6898,298.21
10	116,408.78	29,172.25	6869,125.96
11	115,916.50	29,664.53	6839,461.43
12	115,415.91	30,165.12	6809,296.31
13	114,906.88	30,674.15	6778,622.16
14	114,389.25	31,191.78	6747,430.38
15	113,862.89	31,718.14	6715,712.24
16	113,327.64	32,253.39	6683,458.85
17	112,783.37	32,797.66	6650,661.19
18	112,229.91	33,351.12	6617,310.07
19	111,667.11	33,913.92	6583,396.15
20	111,094.81	34,486.22	6548,909.93
21	110,512.86	35,068.17	6513,841.76
22	109,921.08	35,659.95	6478,181.81

Payment Number	Net Interest	Principal Payment	Balance of Loan
23	109,319.32	36,261.71	6441,920.10
24	108,707.40	36,873.63	6405,046.47
25	108,085.16	37,495.87	6367,550.60
26	107,452.42	38,128.61	6329,421.99
27	106,809.00	38,772.03	6290,649.96
28	106,154.72	39,426.31	6251,223.65
29	105,489.40	40,091.63	6211,132.02
30	104,812.85	40,768.18	6170,363.84
31	104,124.89	41,456.14	6128,907.70
32	103,425.32	42,155.71	6086,751.99
33	102,713.94	42,867.09	6043,884.90
34	101,990.56	43,590.47	6000,294.43
35	101,254.97	44,326.06	5955,968.37
36	100,506.97	45,074.06	5910,894.31
37	99,746.34	45,834.69	5865,059.62
38	98,972.88	46,608.15	5818,451.47
39	98,186.37	47,394.66	5771,056.81
40	97,386.58	48,194.45	5722,862.36
41	96,573.30	49,007.73	5673,854.63
42	95,746.30	49,834.73	5624,019.90
43	94,905.34	50,675.69	5573,344.21
44	94,050.18	51,530.85	5521,813.36
45*	93,180.60	60,108.72	5461,704.64
46	92,166.27	61,123.05	5400,581.59
47	91,134.81	62,154.51	5338,427.08
48	90,085.96	63,203.36	5275,223.72
49	89,019.40	64,269.92	5210,953.80
50	87,934.85	65,354.47	5145,599.33
51	86,831.99	66,457.33	5079,142.00
52	85,710.52	67,578.80	5011,563.20
53	84,570.13	68,719.19	4942,844.01
54	83,410.49	69,878.83	4872,965.18
55	82,231.29	71,058.03	4801,907.15
56	81,032.18	72,257.14	4729,650.01
57	79,812.84	73,476.48	4656,173.53

Payment Number	Net Interest	Principal Payment	Balance of Loan
58	78,572.93	74,716.39	4581,457.14
59	77,312.09	75,977.23	4505,479.91
60	76,029.97	77,259.35	4428,220.56
61	74,726.22	78,563.10	4349,657.46
62	73,400.47	79,888.85	4269,768.61
63	72,052.35	81,236.97	4188,531.64
64	70,681.47	82,607.85	4105,923.79
65	69,287.46	84,001.86	4021,921.93
66	67,,869.93	85,419.39	3936,502.54
67	66,428.48	86,860.84	3849,641.70
68	64,962.70	88,326.62	3761,315.08
69	63,472.19	89,817.13	3671,497.95
70	61,956.53	91,332.79	3580,165.16
71	60,415.29	92,874.03	3487,291.13
72	58,848 04	94,441.28	3392,849.85
73	57,254.34	96,034.98	3296,814.87
74	55,633.75	97,655.57	3199,159.30
75	53,985.81	99,303.51	3099,855.79
76	52,310.07	100,979.25	2998,876.54
77	50,606.04	102,683.28	2896,193.26
78	48,873.26	104,416.06	2791,777.20
79	47,111.24	106,178.08	2685,599.12
80	45,319.49	107,969.83	2577,629.29
81	43,497.49	109,791.83	2467,837.46
82	41,644.76	111,644.56	2356,192.90
83	39,760.76	113,528.56	2242,664.34
84	37,844.96	115,444.36	2127,219.98
85	35,896.84	117,392.48	2009,827.50
86	33,915.84	119,373.46	1890,454.02
87	31,901.41	121,387.91	1769,066.11
88	29,852.99	123,436.33	1645,629.78
89	27,770.00	125,519.32	1520,110.46
90	25,651.86	127,637.46	1392,473.00
91	23,497.98	129,791.34	1262,681.66

Payment Number	Net Interest	Principal Payment	Balance of Loan
92	21,307.75	131,981.57	1130,700.09
93	19,080.56	134,208.76	996,491.33
94	16,815.79	136,473.53	860,017.80
95	14,512.80	138,776.52	721,241.28
96	12,170.95	141,118.37	580,122.91
97	9,789.57	143,499.75	436,623.16
98	7,368.02	145,921.30	290,701.86
99	4,905.59	148,383.73	142,318.13
100	2,401.62	142,318.13	144,719.75

D. Ex. 11

WORTHEN BANK AND TRUST COMPANY
Little Rock, Arkansas 72203

November 28, 1969

New York Life Insurance Company
51 Madison Avenue
New York, New York 10010
Attention: Vice President of Real Estate &
Mortgage Loans

Gentlemen:

This to certify to New York Life Insurance Company that as of October 31, 1969, the records of Worthen Bank and Trust Company show that it has paid in connection with the total cost of the Mortgaged Property (as defined in Paragraph 2(E) of the Consent and Agreement dated May 1, 1968, between Worthen Bank and Trust Company and New York Life Insurance Company) as follows:

Payment to Matson Bellows Co.

General Conditions	531,325
Excavation	42,271
Foundation Drilling	191,116
Concrete, Forms & Reinforcing	1,419,167
Pans	—0—
Precast Concrete	—0—
Masonry & Brick Pavers	193,000
Steel Girders	3,011
Miscellaneous Metal	41,233
Hollow Metal	10,032
Millwork & Rough Carpentry	88,803
Lath & Plaster	192,922
Drywall	56,520
Painting	46,802
Sandblasting	98,171

Ceramic Tile	58,250	
Mechanical	627,357	
Electrical	490,100	
Elevators	481,500	
Acoustical Ceiling	30,963	
Glass & Glazing	275,000	
Roofing & Sheet Metal	56,537	
Waterproofing—Basement	7,183	
Waterproofing & Caulking	22,500	
Elastrometric Waterproofing	14,210	
Light Weight Concrete	846	
Rolling Steel Doors	3,300	
Polyurthane Insulation	11,368	
Garage Parking Equipment	—0—	
Rubbish Chute	1,569	
Resilient Flooring	2,570	
Toilet Partitions	2,681	
Toilet Accessories	48	
Finish Hardware	—0—	
Motorized Drape Track & Doors	2,690	
Mail Chute	8,800	
Folding Partitions	—0—	
Contractors Fees	205,200	
		5,217,045.00
Architect Fees		398,515.43
Construction Consulting Fees		61,592.78
Interior Design Consulting Fees		187,492.72
Other Consulting and Engineering Fees		57,020.49
Materials-Concrete, Forms Lumber, Steel		
Concrete, Forms & Reinforcing	961,522	
Precast Concrete	380,440	
		1,341,962.00

Equipment Rental		
Pans	181,360	
Miscellaneous, Others	34,323	
		215,683.00
Other Material, Supplies, etc.		
General Condition	360,728	
Excavation	15,967	
Foundation Drilling	164	
Masonry & Brick Pavers	54,923	
Steel Girders	36,184	
Miscellaneous Metal	100,227	
Millwork & Rough Carpentry	246,001	
Hollow Metal	21,922	
Lath & Plaster	52,808	
Drywall	19,838	
Painting	15,740	
Sandblasting	46,901	
Ceramic Tile	28,185	
Mechanical	666,031	
Electrical	327,994	
Elevators	127,778	
Acoustical Ceiling	67,385	
Roofing & Sheet Metal	1,332	
Light Weight Concrete	653	
Polyurthane Insulation	16,286	
Garage Parking Equipment	26,979	
Rubbish Chute	4,000	
Resilient Flooring	10,050	
Toilet Accessories	9,458	
Finish Hardware	29,439	
Motorized Drape Track & Doors	5,950	
Folding Partitions	5,975	
		2,298,898.00
Legal and Accounting Fees		53,743.05

Interim Interest on Construction Funds Borrowed	399,848.54
Land	1,435,299.95
	11,667,100.96

By /s/ FRANK T. MCGEHEE
Frank T. McGehee
Assistant Vice President

(Subscription Omitted in Printing)

D. Ex. 12

COTHAM, WYMAN & HOWLAND
Certified Public Accountants
PYRAMID LIFE BUILDING
LITTLE ROCK, ARKANSAS
72201

New York Life Insurane Company
Attention: Vice President in Charge of
Real Estate and Mortgage Loans
51 Madison Avenue
New York, New York 10010

Re: Worthen Building and Garage

Pursuant to Paragraph 2(E) of the Consent and Agreement dated May 1, 1968 between Worthen Bank & Trust Company and New York Life Insurance Company, this is to certify that the Total Cost of the Mortgaged Property as defined below is at least $9,500,000.

The Total Cost of the Mortgaged Property is defined as: (1) the total cost of the Worthen Building; (2) the aggregate of costs reasonably incurred and paid by Worthen Bank & Trust Company in connection with the acquisition of the land underlying the Worthen Building and Garage and charged and properly chargeable to the property accounts of the Bank in accordance with generally accepted accounting principles; (3) the aggregate of the costs reasonably and necessarily incurred and paid by the Bank in connection with the construction of the garage facility and charged and properly chargeable to the property account of the Bank in accordance with generally accepted accounting principles.

A detailed breakdown of expenditures for the period May 13, 1966 to November 18, 1969 is shown below:

Payments to Matson-Bellows Construction Company	$ 4,786,371.00
Architect Fees	398,515.43
Construction Consultant Fees	61,592.78
Interior Design Consulting Fees	187,492.72
Other Consulting and Engineering Fees	57,020.49
Materials—Concrete, Form Lumber, Steel	1,291,534.25
Equipment Rental	215,683.78
Other Materials, Supplies, etc.	2,190,674.17
Legal and Accounting Fees	53,743.05
Interim Interest on Construction Funds Borrowed	399,848.54
Land	1,435,299.95
	$ 11,077,776.16

Dated this 25th day of November, 1969.

COTHAM, WYMAN & HOWLAND

By ——————————, C.P.A.
Members American Institute of
Certified Public Accountants

(Subscription Omitted in Printing)

D. Ex. 13

September 2, 1966

Mr. Harry E. Meek, Attorney
Rose, Meek, House, Barron, Nash & Williamson
720 West Third Street
Little Rock, Arkansas 72201

Dear Mr. Harry:

In connection with the proposed financing of our new bank structure, we would like to explore the possibility of organizing a subsidiary corporation to own the building and in turn, lease the building to Worthen Bank. The subsidiary corporation would negotiate a mortgage loan based on ownership of the building site and the long term lease from Worthen Bank.

To set up the subsidiary corporation the bank could either purchase the building site and deed it to the subsidiary corporation in return for one hundred percent holdings of the subsidiary corporate capital stock. Another alternative would be for Worthen Bank to spin off the real property to the XYZ Corporation.

We are trying to determine the best procedure for the financing and of course, the answers to the above will enable us to take depreciation of the improvements and real estate taxes into consideration in arriving at the best plan to follow.

If you have any other suggestions as to the organization of a corporation to hold title, please let me have your thinking. Of course, as an alternative to the above methods the bank could sell the property to a non-affiliated corporation, and lease it back from them. This might be the most feasible plan but could be more expensive.

An opinion from you relative to the above will be appreciated.

Sincerely,

RICHARD F. GATES
Vice President

D. Ex. 14

ROSE, MEEK, HOUSE, BARRON, NASH & WILLIAMSON
ATTORNEYS AT LAW
720 WEST THIRD STREET
LITTLE ROCK, ARKANSAS 72201

October 13, 1966

Worthen Bank & Trust Company
401 Main Street
Little Rock, Arkansas
Attention: Mr. Richard Gates

Dear Mr. Gates:

Please refer to your letter of September 22, 1966.

I understand the bank, in connection with the construction of its new banking house, is considering the following procedure:

1. The bank will create a wholly-owned subsidiary having a rather nominal capitalization.

2. The bank will convey the building site to the subsidiary at a price equal to the cost incurred by the bank in purchasing the building site. In exchange for this conveyance all shares of the subsidiary would be issued to the bank.

3. The subsidiary would obtain a mortgage loan from some institutional lender in an amount equal to the land cost and the cost of constructing the building. If a 100% loan could not be procured, the bank would have to absorb some part of the land cost.

4. The subsidiary will cause the building to be constructed.

5. Subsidiary will then lease the land to the bank for a leasehold term at a rental which will be determined by

the terms and debt service requirements of the subsidiary's mortgege.

6. The subsidiary will mortgage to the institutional lender the land and building and also assign to the lender its rights as lessor under the lease contract; this assignment being given as additional collateral for the lender.

7. The lease will have to be a net lease, with the bank assuming full responsibility for maintenance, taxes, insurance, etc. The lease will contain a provision giving the bank an option to purchase the property, at a nominal price, when all rentals under the lease are paid.

I will discuss different aspects of this matter.

I

INCOME TAX CONSEQUENCES

The Treasury Department would take the position, so far as tax consequences are concerned, that the bank is obtaining a loan on the building, and would disregard the fact that the title is vested in the subsidiary and that the loan is being obtained by the subsidiary. The Treasury Department would treat the lease contract (held by the lender as assignee of the subsidiary) as being in reality a security agreement. Therefore, the Treasury Department would do the following in respect to income tax liabilities:

(a) The bank could not deduct the rentals paid by it to its subsidiary as a business expense for tax purposes.

(b) The bank could, however, claim a deduction for the portion of each rental payment allocable to the loan interest. Of course this deduction would be diminished as the loan was retired.

(c) The bank could claim depreciation.

(d) No capital gain or loss would be recognized in connection with the transfer from the bank to its wholly-owned

subsidiary. This is due to the fact that from a mathematical standpoint there would probably be no gain or loss; and also to the fact that the transaction would be a non-taxable corporate adjustment.

(e) The bank and the subsidiary could file separate returns; and the subsidiary's return would show the rent received as non-taxable income. A consolidated return could be filed if your accountants felt that this was desirable.

A bank in northeastern Arkansas effected a sale and leaseback transaction of this character early this year; and I enclose a copy of the opinion of the local Treasury Department office in respect to this transaction. Worthen should obtain such a preliminary opinion when its plans are crystalized.

I also enclose a Xerox copy of an article on sale and leaseback of bank and premises written by Lewis Greenblatt—Mr. Greenblatt being a New York attorney. I have two additional law review articles on the subject but I will not burden you with them.

In reaching the conclusions above set out, I consulted the following authorities:

Helvering vs. Lazarus & Company, 308 U.S. 252, decided in 1939.

Leeds & Lippencott Company vs. U.S., 276 Fed. 2d 927, decided in 1960.

Paul W. Frenzel and Paula S. Frenzel vs. Commissioner, 22 T.C.M., page 1391, decision 26,347, handed down in 1963.

Shaffer Terminals, Inc. vs. Commissioner, 16 T.C. 356, decided in 1951.

Frito-Lay Co. vs. U.S., 209 Fed. Supp. 886 (1962).

Century Electric Co. vs. Commissioner of Internal Revenue, 192 Fed. 2d 155 (1951).

II

AUTHORITY OF BANK TO CREATE A BANK PREMISES SUBSIDIARY

Section 113 of our banking act of 1913 spells out in very primitive style the corporate powers of a state bank. It certainly contains no express authorizations for a bank to set up a subsidiary See Section 67-501 of our Code.

However, Section 67-547, enacted in 1955, gives a bank very broad authority to acquire land as a location for its banking house or as a parking lot established for the convenience of its customers; and in my opinion a state bank can effect this acquisition of land either in its own name of its wholly-owned subsidiary.

Where a bank acquires bank premises through a wholly-owned subsidiary, the legality of the tranaction turns on the question of whether the bank violates any banking statute in acquiring all of the capital stock of its subsidiary. A bank, of course, is not permitted to engage generally in the purchase of the shares of business corporations. This restriction is to prohibit investments which might be speculative and might impair the position of the depositors.

But the purchase of the shares of a wholly-owned subsidiary under the circumstances contemplated by Worthen would not amount to an "investment", within the meaning of the banking laws. Such purchase of shares by Worthen would amount merely to a mechanical step utilized by it in acquiring new banking premises in a manner that would ot impair the bank's cash position or show large bills payable liabilities on its books.

In my opinion, the acquisition of the shares of Worthen's subsidiary would offend banking restrictions only if the transaction be regarded as an "investment" within the meaning of the banking laws. But such a transaction will result in no capital gain or loss; it will merely a procedural step taken in financing, in the most favorable manner, the acquisition of the new bank premises; and the purchase of the shares of its wholly-owned subsidiary will not be an unauthorized investment.

The only state court decision dealing with this subject matter which I have been able to find is Fourth National Bank vs. Shahlman, 178 S.W. (Tenn.) Page 942. Here the court approved the purchase by a bank of preferred stock in a building corporation to facilitate the acquisition by the bank of a long term lease from the building corporation of space for banking house premises. The court remarked that the rules restricting a bank's right to purchase stock in other corporations had no application to a situation where the purchase was made as a step reasonably justified in facilitating the acquisition of new banking premises. This suit involved a national bank, but the same principles would apply to a state bank situation.

The Federal Banking Act of 1933, as amended, tacitly authorizes a state member bank to utilize a subsidiary in acquiring its banking premises. This section (12 U.S.C.A. 371d) reads:

> "No national bank, without the approval of the Comptroller of the Currency, and no State member bank, without the approval of the Board of Governors of the Federal Reserve System, shall (1) invest in bank premises, or in the stocks, bonds, debentures, or other such obligations of any corporation holding the premises of such bank or (2) make loans to or upon the security of the stock of any such corporation, if the aggregate of all such investments and loans, *together with the amount of any indebtedness incurred by any such corporation which is an affiliate of the bank, as defined in Section 221a of this title,* will exceed the amount of the capital stock of such bank." (My emphasis.)

See also 12 U.S.C.A. 317c.

In October, 1965 the Arkansas State Bank Commissioner authorized the bank of McCrory to transfer its banking house to a wholly-owned subsidiary in connection with their lease and sale agreement.

III

Right of Bank To Acquire Office Space for Lease to Tenants

It has been held that a national bank may lease or construct a building for banking purposes even though it intends to occupy only a part of the building and to rent out a large part of the building to others. Perth Amboy National Bank vs. Brodsky, 207 Fed. Supp. 785 (1962); Brown vs. Schleier, 118 Fed. 981 (8th Circuit, 1902).

In my opinion the same reasoning which justifies such action on the part of a national bank would be applicable to a state bank.

Before we get too deeply involved in a leaseback arrangement, we should consult Mr. J. G. Williamson and the bank's accountant Ralph Cotham.

Yours truly,

Harry E. Meek

U. S. Treasury Department
INTERNAL REVENUE SERVICE
District Director
Little Rock, Arkansas 72203

December 9, 1965

Mr. John D. Eldridge
Vice President, Bank of McCrory
Haralson-Eldridge Building
Augusta, Arkansas 72006

Dear Mr. Eldridge:

You have inquired about the tax consequences of a proposed transaction which involves the sale, by a Bank of McCrory, of its plant (building and all fixtures) to its wholly owned subsidiary, and simultaneously leasing the plant back for a rental which will, over the full term of the lease, equal the principal and interest payments necessary to liquidate a purchase-money loan to be borrowed by the subsidiary. The loan will equal the purchase price the subsidiary will pay for the plant. Under the terms of the lease, the Bank will have the option of reacquiring the plant for $1.00 at the end of the lease period.

You also said that the Bank will pay all taxes, insurance, and maintenance costs relative to the plant.

Thus, the subsidiary will simply collect the principal and interest payments from the Bank, and pass them on to the mortgage.

As you suggested, the proposed transaction is, in substance, a mere mortgaging of the plant by the Bank. Therefore, the sale and leaseback will not be recognized for Federal income tax purposes. The bank will not be allowed a deduction for lease rental paid to the subsidiary, nor would the subsidiary be deemed to have received taxable rental income. The Bank would, however, be allowed a deduction for interest paid on the mortgage.

This letter represents an opinion and does not constitute an official determination or ruling.

Sincerely,

/s/ Fred W. Johnson
Fred W. Johnson
District Director

Financing Through Sale and Leaseback of Banking Premises

Louis Greenblatt

Mr. Greenblatt is a senior partner of the New York City law firm of Tenzer, Greenblatt, Fallon & Kaplan. He is a director of a number of public corporations and has for many years been a Lecturer for the Practising Law Institute in New York City on real estate and tax matters.

It is the purpose of this article to review several methods of adding to the capital of a bank, as well as to its liquidity, with special emphasis on the use of sale and leaseback transactions to accomplish both of these objectives.

The expansion of our economy, with the concomitant expansion of banking as a whole, poses a number of serious problems for many banks. Particularly affected are those banks that have increased the volume of deposits and loans, but whose capital has not been enlarged in the proportions required to support these increases. Some banks are in a weak reserve position because their working capital ratio to deposits is too low to meet the requirements of the Federal Reserve Bank and local banking authorities. Others are in a weak capital position because the ratio of total capital to total deposits does not meet the necessary ratio requirements of the Federal Reserve Bank and of local State Banking Departments.

All banks are closely watched and checked to make certain that liquidity and capital ratio positions are at all times sufficient to enable them to meet all demands which may reasonably be made on them by demand depositors. In considering a bank's financial condition for both Federal and local Banking Department purposes, all of the bank's assets are separately analyzed for liquidity and availability to meet demand deposit requirements. All assets are rated, and liquid assets are treated as capable to support deposits on a much higher ratio than that applied to fixed assets. For reserve purposes, fixed assets are completely eliminated from consideration. For the purpose of support of total volume of deposits, fixed assets may be treated as having a ratio of one to one whereas liquid assets may have a ratio of as much as twenty to one.

Under the rules of the Federal Reserve Bank it is necessary for a "City" bank to maintain reserves of 16½% of demand deposits, and for so-called "Country Banks" to maintain reserves of 12% of demand deposits. These reserves are frozen either by non-interest bearing deposits with the Federal Reserve Bank or by maintaining actual cash on hand. It thus becomes necessary for bank managers to maintain sufficient working capital resources to comply with these reserve requirements as well as those prescribed by State Banking Laws. As has been pointed out, in calculating the amounts creditable for such reserve purposes, only liquid assets are considered. How to obtain additional working capital to meet these requirements is, therefore, a problem of first magnitude for those in charge of the bank's operations.

Furthermore, in many cases a bank may be growing at a rapid rate and its deposits may be increasing at a rate that makes it desirable to expand its operations or to increase its facilities. This may require a considerable amount of additional investment in fixed assets, which the bank may ill afford to freeze; to do so may change the working capital ratio of the bank. This may require the bank's management to consider the effect of the cost of the expansion or new facility on the entire capital structure. Does the program require that additional capital be raised? If so, how shall it be done?

Bank management thus faced with the need for additional capital and an increase in its *working* capital must then determine the route to be taken to obtain the necessary additional capital for any or all of the foregoing purposes.

Prior to 1930 it was almost the universal policy of banks to increase their capital by rights subscriptions for common stock. During the depression, the sale of bonds and preferred stock was authorized, but principally as a method of financing distress conditions. It was the policy of the Comptroller of the Currency with respect to National Banks, and also the policy of State Banking Departments, to discourage and restrict senior capital financing. This attitude, however, has changed in recent years, and both the Comptroller of Currency and many State Banking Departments, now appear to approve senior capital financing and the issuance of senior debt securities.

A number of avenues to obtain additional capital and liquidity are available, and they may be used singly or in a combination of some or all of them. In summary, they are as follows:

- The issuance of rights to the existing common stockholders to purchase additional common stock;
- The issuance of preferred stock, with or without voting rights, with or without a definite retirement program, and with or without convertibility;
- The issuance of subordinate debenture notes payable over long terms. These also may be with or without conversion rights;

• The sale and leaseback of its banking property.

Bank management is required to carefully analyze the method or combination of methods of raising additional capital funds that are available and to select the method which can be used to the best advantage. In each instance, the route to be taken by a given institution is entirely dependent upon the financial condition and requirements of the individual institution.

Rights

The issuance of rights to the common stockholders is the oldest and most conventional method of obtaining additional capital. However, this sometimes has the disadvantage of causing dilution of the interests of the common stockholders because some of the stockholders may not be in a position to exercise the rights. This method may be particularly undesirable in smaller closely-held banks because management does not want to, or is not able to, invest additional capital funds in the bank and at the same time does not want to give up actual control of the bank. It may also be undesirable because the amount of additional capital that may be needed may be more than may be available through a rights issue. Most banks, large and small, in recent years have been avoiding rights issues because of a desire not to cause dilution of the common stockholders' interests. Especially is this so where funds are available through other means, and the bank could earn more than the cost of the debt service, thus increasing the total earnings of the bank and the net earnings per share for the existing stockholders.

Debentures

In some instances the capital structure of the bank is such that the issuance of debenture notes would be most desirable. This is so in cases where the additional capital desired is not disproportionate to the bank's existing capital, and would not create an imbalanced ratio between capital and debt. Good money management would seem to indicate that the debt should not exceed 30% of the capital. Usually these funds are available at comparatively low cost. Moreover, the cost of interest is tax deductible, and the debentures do not dilute the interests of common stockholders. Bankers Trust Company in New York City recently found it desirable to issue One Hundred Million Dollars of 4.5% subordinate debenture notes, in preference to any other method of obtaining working capital. Crocker-Citizens National Bank in San Francisco recently announced that it is planning a new One Hundred Million Dollar 4.6% subordinate debenture issue. In both cases, the additional money so obtained has the effect, for reserve purposes, of supporting about $600,000,000 of additional deposits and, at the same time increases the bank's lending limit on any individual transaction by an additional $10,000,000.

Preferred Stock

The issuance of preferred stock has the advantage of being attractive to corporate investors, such as insurance companies or other investment institutions that have large amounts of investment funds available. To such a corporate holders, 85% of the dividends received on the preferred stock is tax sheltered by exclusion of this amount from Federal income taxes and only 15% is includible. Thus the net yield is far greater, after taxes, than any yield on a straight debt issue. The issuance of preferred stock has an advantage in that it does not dilute the interests of the common stockholders. The disadvantage to the bank, however, is that the dividends payable on the preferred stock are not deductible as an expense of operations but are paid out of after-tax paid earnings. Recently, the Franklin National Bank on Long Island, New York issued Twenty Million Dollars of 4.6% preferred stock. In addition, it raised approximately Thirty Million Dollars by way of a deben-

ture issue and an additional Sixteen Million Dollars by way of a sale and leaseback transaction. This bank thus used all three methods to raise additional capital *without diluting the common stock* of the bank.

Sale-Leaseback

The use of a sale-leaseback method of obtaining capital has a number of advantages. In most cases a bank has between 15% and 20% of its capital invested in its bank buildings and this investment is treated by the bank on its balance sheet as a fixed asset. Such an asset is valueless for reserve purposes and, as will later be shown, has no value for leverage purposes. By making a sale-leaseback transaction, either with a wholly owned subsidiary or with an independent third party, the fixed asset is immediately converted into a cash liquid asset. In many cases, the value of the property is much greater than the amount at which it is carried on the books. The making of the sale-leaseback at the higher value will thus bring about an increase in the total amount of capital of the bank, in addition to the conversion of a fixed asset into a cash asset. In and of itself, this conversion from a frozen asset to a liquid asset will greate a great deal of leverage for the bank with which to support additional deposits and permit it to increase its lending limits. All of this is accomplished without the creation of a debt liability on its balance sheet (although it will be obligated on the lease), and without diluting the interests of the common stockholders.

We will now proceed to show some of the details of a sale-leaseback transaction, including the cost and tax consequences thereof, and how its use will be of advantage to a bank as a method of increasing its capital liquidity and its earnings.

SALE AND LEASEBACK TRANSACTIONS WITH A WHOLLY OWNED SUBSIDIARY

Throughout the years, banks have had a strong desire to own their principal quarters. There was a reluctance to dispose of their property. By a sale and leaseback with a wholly owned subsidiary, a bank can convert its fixed asset to cash and still retain control of its property.

Let us assume that a bank owns property which has a depreciated book value of $500,000 but a market value which, together with the leaseback, will make it mortgageable for $1,000,000; that the property is sold for $1,000,000 to a wholly owned subsidiary which leases it back to the bank on a long-term lease at a net rental sufficient to support the debt service on a $1,000,000 mortgage loan made to the subsidiary, secured by a lien on the property, and an assignment of the bank lease. Out of the proceeds of the mortgage the subsidiary pays the bank the $1,000,000 purchase price. This amount is received by the bank in place of the $500,000 book value of the fixed asset. The transaction would be consummated as follows:

- The bank organizes a wholly owned subsidiary with a nominal capital. The subsidiary is authorized by its charter to own and hold real estate and equipment, and to buy, sell, lease and mortgage same, etc.

- The bank conveys its property to the subsidiary at a price of $1,000,000 and simultaneously executes a net lease with the subsidiary. The term of the lease and the amount of rent to be paid will be determined by the term and the debt service requirements of the mortgage. This will be referred to in more detail later.

- The subsidiary then executes the mortgage on the property to the lending institution, and at the same time it assigns the lease with the bank to the lender as additional collateral security.

• The subsidiary then uses the proceeds of the mortgage to pay the bank the $1,000,000 purchase price.

When properly handled, the following are accomplished:

Bank Balance Sheet

The bank's statement will show an increase in cash by $1,000,000. (This is rounded out and does not consider mortgage costs, legal charges or title closing costs incurred in consummating the transaction.) Fixed assets of $500,000 are eliminated. The *actual* capital of the bank is increased by $500,000. The lease liability does not appear as a balance sheet obligation, although a footnote relating thereto may be inserted by the accountants. Thus we have increased the *working* capital of the bank by $1,000,000, and the *actual* capital by $500,000.

Tax Consequences

All of the foregoing are without any tax consequences resulting from the transaction. The Internal Revenue Service has repeatedly held that it will disregard the *form* of the transaction and will look only to the *substance*. It will treat the entire transaction as a mortgage by the bank and will disregard the form used to accomplish this result. Therefore, no capital gain or loss will be recognized. After the transaction is completed the rental paid would be treated for tax purposes in exactly the same manner as if no sale-leaseback transaction had been made. Depreciation would still be taken on the same basis as before the sale and leaseback; interest only which is paid on the mortgage would be allowed as an expense, but not the amortization payments. Where a sale-leaseback transaction is made with a wholly owned subsidiary, the bank and the subsidiary each file separate returns. It has been the practice of banks to ask for and get a prior ruling from the Internal Revenue Service approving the transaction as non-taxable, and a copy of this ruling is attached to the returns of both the

bank and the subsidiary. The subsidiary files a return showing the rent received as non-taxable, and it shows no taxable income, and also attaches a copy of the Internal Revenue Service ruling, or a statement of the transaction. It is also acceptable accounting practice to file a consolidated return for the bank and the subsidiary. The form to be adopted is determined by the bank's accountants and may be influenced by other considerations, such as other wholly or partly owned corporations, etc.

Lease Provisions

A few of the clauses to be inserted in the lease are:

• The lease should be for an initial term of years to coincide with the mortgage terms available. Usually the mortgage will be self-liquidating over a period of years with constant payments of a fixed sum applicable first to the payment of interest at the agreed upon rate and the remainder to reduction of principal. The term of the lease should be for at least as long as it takes to liquidate the mortgage debt.

• The lease should give the bank one or more options to extend the term at a nominal rent after the expiration of the initial term. It may conceivably be desirable for the bank not to want the fixed asset to reappear on its statement.

• The lease should give the bank lessee an option to repurchase the property at any time, subject to the obligations under the mortgage, or at the end of the lease term for a nominal consideration. This may prove to be a cheaper way to reacquire ownership of the property by the bank than to merge the subsidiary into the parent.

• The mortgage to be executed by the subsidiary should have some prepayment privilege before maturity of the mortgage, either with or without penalty, depending on the terms and conditions agreed upon with the lender at the

time that the mortgage is obtained. The lease should permit the bank to cancel the lease at any time, provided it makes provision for the payment or assumption of payment of the unpaid balance due on the mortgage. At the time of cancellation of the lease the bank may also exercise clause.

• The lease should provide that in case of substantial damage by fire which requires rebuilding, all proceeds should be applied to reconstruction of the property to its original condition unless the bank elects that it shall be applied in reduction of the mortgage. In the latter event the bank should be privileged to pay off the remaining balance due on the mortgage and have it satisfied. This gives the bank the choice of repairing the damage and rebuilding the existing structure, or to rebuild an entirely new, larger, and more valuable structure and make a new sale-leaseback transaction for the new structure for a much larger amount. This may prove to be advantageous where valuable land was not theretofore used for its full economic value.

• The lease should have a condemnation clause that gives recognition to the interest of the bank as lessee for the unexpired term and the options. Hence the lease should provide that in the event of condemnation, all of the award in excess of the unpaid balance due on the mortgage should be paid to the bank.

• The lease should protect the bank against liability for damage by fire even if caused by the bank's negligence. Hence, the lease should require that all fire insurance policies shall exclude any right of subrogation against the bank or its subsidiary for any fire damage, regardless of the cause of such damage, even including the negligence of the bank or its employees.

• The lease should give the bank the right to assign the lease, or sublet the premises, but without release of the bank's obligation as lessee.

• The lease should be a "net lease," that is to say, the bank should be required to pay all taxes on the property, to maintain the latter in good repair, including compliance with all laws and ordinances affecting the property, and to insure the property against the risk of fire and all other insurable risks such as those comprehended within "extended coverage" and also war risk insurance when the latter is available. The lease, moreover, should provide that there is no abatement or diminution in rent because of any damage or destruction to the premises by any cause whatsoever.

• The lease should permit the bank to make alterations and renovations and under certain conditions acceptable to the mortgagee so as not to affect its security, to demolish and rebuild.

• The lease should be subordinate to the mortgage but the subordination clause should provide that so long as the bank pays its rent and otherwise complies with its obligations under the lease, it will not be disturbed in its possession of the demised premises.

SALE AND LEASEBACK TRANSACTIONS WITH THIRD PARTIES IN ARMS-LENGTH TRANSACTIONS

It is not often that a bank will desire to make a completely arms-length sale and leaseback of its property with a third party, but there may be circumstances under which this kind of transaction may be preferred. This may be a desirable method where a bank has fully depreciated its property and it is carried on its books for the land value only. It may be profitable for the bank to realize the full value of the property in cash, and pay a capital gains tax at low rates. Thereafter, it will take full deduction for all of the rent paid. Another instance in which a bank may prefer an arms-length transaction is where a bank desires a new building. It may be cheaper for it to build the new structure in the first instance, and then make a sale-lease-

back transaction which will recoup its investment. In all likelihood the rent to be paid will be lower than if the building were built by a third party and then leased to the bank.

Let us assume that a bank has a fully depreciated property carried on its books for $100,000, that being its land value. Let us also assume that it can sell the property for $1,000,000 and lease it back at a net rent of $70,000 per year for a term of 25 years, with one 20-year renewal option at $35,000 per annum and three additional renewal options for 20 years each at $17,500 per annum. Under the current income tax rates, the bank would pay about 25% of $900,000 as a capital gains tax, or about $225,000, and it would retain $775,000 as a net cash asset in place of $100,000 of fixed assets. In this manner, it would add $775,000 of working or liquid capital, and $675,000 to the total capital of the bank, without creating any liability on its statement. All of this would be cash or liquid capital with its full leverage and asset-ratio advantages. Thus there has been created $775,000 of additional working capital with which to produce income. Before the transaction, the bank had no depreciation deduction, but after the transaction, the bank will deduct the full $70,000 rent paid as an expense. The net cost after taxes would then be about $35,000 per year. It can be readily seen and we point out below some of the details that in almost all cases a bank should be able to earn more on the additional capital created than the cost of this debt service.

In an arms-length transaction the lease will be more in line with the usual long-term net lease, but should particularly include:

• A non-disturbance agreement applicable to any owner or mortgagee which would provide in substance that so long as the bank pays the rent and otherwise complies with its obligations under the lease, the bank will not be disturbed in its possession of the premises.

• The lease should include protection to the bank for its interest in the lease in the event of condemnation. A full schedule of amounts to be allocable to landlord and tenant should be attached giving the owner his undepreciated value of the property and provide for the payment to the bank of the value of its leasehold. The foregoing is, of course, apart from the bank's right to assert its separate claim for its trade fixtures and equipment that are condemned.

• The lease may include a purchase option. However, extreme care must be used to make sure that the provisions of the option and the terms and price of repurchase do not make the transaction an illusory one. If there is such an illusion, the consequence will be that for Federal tax purposes the transaction will be treated as a mortgage and not a sale with the resulting loss of rent deductions—at least to the extent that these exceed a reasonable interest rate.

THE COST OF SALE-LEASEBACK TRANSACTION

The cost of a sale-leaseback transaction—assuming it to be with a wholly owned subsidiary—is directly related to the value of the property and the strength of the bank as lessee. In all cases the bank is required to pay all maintenance costs, insurance, taxes and other charges. We will only consider the costs of the financing of the sale-leaseback transaction. The Chase Manhattan Bank in New York City was able to procure a $60,000,000 mortgage at 4% interest on its headquarters building at Chase Manhattan Plaza. Franklin National Bank on Long Island borrowed about $16,000,000 at an interest of 4.7%. Smaller banks will find that an interest cost of 4.75% to 5.5% is about the going rate. Of course, there must be added the amount of amortization payments on the debt and these payments will be determined by the length of term of the self-liquidating mortgage. Usually, the payments are constant level payments and are payable quarterly. The cost of procuring

the financing, such as underwriting fees, brokerage, legal fees, title insurance and like charges are usually charged off, at least for tax purposes, in equal installments over the term of the mortgage. The amount of such costs vary, but should not exceed a total of between 2% and 3% of the amount obtained.

Where an arms-length transaction is made, it is generally at a rental which will reimburse the owner for his full investment and also give him a rate of return about equal to that of a mortgage. However, the income under the lease continues during the entire term of the leaseback and any renewals and at the end of the lease belongs to the purchaser. In recent days it has been the practice of lending institutions to fix the rental at 50% of the original rent for the first renewal term of years, and 25% of the original rent thereafter.

In comparison with the above, interest on subordinate debentures vary from 4½% (as paid by Bankers Trust Company in New York City) up to 5½% paid by smaller banks. This also is the range of rates for preferred stock, but at about ¼ of 1% higher because stock is a capital investment rather than a debt.

EFFECT ON FEDERAL DEPOSIT INSURANCE CORPORATION PREMIUMS

The Federal Deposit Insurance Corporation charges its member banks a premium based on the total amount of deposits. It does not segregate accounts which have more or less than $10,000 balances, although its obligation on any one account is limited to $10,000. The premium cost is 1/12 of 1% of average deposits based on calls made quarterly. Usually the premium cost is reduced by a credit of between 55% and 60% of the fixed rate, based on experience. Thus the ability of a bank to maintain and support larger amounts of deposits because of its increased capital may

cause an increase in its premium cost, but the amount of such additional premium cost is so nominal as to be of no real concern to any bank when considering its capital needs.

APPLICABILITY TO NEW YORK CITY BANKS

In 1963 the City of New York adopted an Occupancy Tax Law which has recently been upheld by the Court of Appeals of the State of New York—the highest court in the State. Under this enactment an annual occupancy tax is levied on tenants at the rate of 5% of the annual rental when the latter is in excess of $2,500 per annum, but no tax is payable where premises are owner-occupied. As a result of this tax it appears that a bank is required to pay the Occupancy Tax on the rent paid to the subsidiary, but no Occupancy Tax is required if the bank remains the owner. Although for Federal income tax purposes the form of the transaction is disregarded and the substance only is controlling, it is believed that for the purpose of liability for the Occupancy Tax the form of the transaction is controlling. As a result of this tax, New York City banks have had some second thoughts on sale-leaseback transactions. Recently the Chase Manhattan Bank entered into such a transaction with a wholly owned subsidiary, and executed a long-term lease at a very large annual rent. This would have cost the bank more than $500,000 annually for the Occupancy Tax. Before the tax became effective it reversed the transaction, and reacquired the property, so that it became an owner-occupant. To do so, it made arrangements with the New York State Teachers Retirement Fund which held a $60,000,000 mortgage to accept repayment in advance and release the mortgage as a lien on the property. It then cancelled the lease agreement made with its wholly owned subsidiary. This was also done by Manufacturers Hanover Trust Company when it exercised its option to purchase its banking headquarters on Park Avenue in New

York City from Uris Building Corporation. The possibility of such an occupancy tax in places other than New York City should always be considered when embarking on a sale and leaseback, and adequate precaution taken to permit reversal of the transaction if the local jurisdiction should follow New York City's lead and enact a similar tax.

CAPITAL ADEQUACY AND ASSET-RATIO AND ITS RELATION TO SALE AND LEASEBACK

It might be well to dwell briefly on the over-all problems of capital adequacy, asset-ratios and leverage of bank assets and capital, and the impact that a sale and leaseback has on these. Bank management is always on the alert to make the utmost use of its available assets, but the bank must always be sure that this is done without violating the Federal Reserve Bank requirements, and without inviting criticism from the State Banking Department.

It must be emphasized that a bank must at all times be so conducted that its capital structure and asset-ratio is adequate for the operation of its business. In determining capital adequacy, the Federal Reserve Bank and local Banking Departments make detailed studies of each bank's portfolio, and assign a value to each asset. They also apply a "risk-assets" formula to each asset to obtain proper ratios. The formula varies in many states and between State and National Banks and between different parts of the country. As an illustration of the application of the risk-asset formula ratings to asset categories, a 100% riskless rating is given to U.S. Government securities, 75% to AAA securities, etc.

In almost all cases, the entire fixed asset investment of a bank is deducted from the capital structure, or reduced to utility value, before computing the asset or capital ratio. In the case of a small bank, the fact that it has a substantial investment in fixed assets may have the effect of

reducing its capital adequacy and asset ratio to a point where it is seriously hampered in its growth and its ability to properly serve its customers. By unfreezing its fixed assets via a sale-leaseback transaction, and converting such fixed asset into cash, a bank will be able, at least to the extent of such conversion, to improve its working capital and asset-ratio picture. This will enable it to (1) have cash assets which can be used to provide increased reserve requirements; (2) this in turn will support six to eight times the amount in added demand deposits; (3) this in turn adds that much more to the amount which the bank can lend to its customers. The bank generally requires borrowers to keep about 20% of the amount of loans on deposit as average balances, which provides still further leverage for reserve and lending purposes.

All of this is accomplished without creating any debt liability on the balance sheet and without diluting the interest of its stockholders.

SALE AND LEASEBACK AND EFFECT ON EARNINGS

A bank's ability to utilize its funds fully and continuously determines its ability to earn profits. We have shown how the increase in working capital can support between six and eight times the amount of that capital in additional demand deposits. Such increase can support even more than this amount in time deposits. Let us then analyze what this means to a bank's gross earnings, net earnings and earnings per share.

Let us assume that a sale and leaseback transaction results in the conversion of a fixed asset to a cash asset in the sum of $1,000,000 and that the debt service for this is 5% per annum. We then can accomplish the following:

△ The cash received will support at least $6,000,000 of additional demand deposits. This figure will be more in a "Country" bank and more for time deposits.

△ These additional deposits will enable the bank to make additional loans to its depositors of about $6,000,000 at between 5½% and 6% per annum. A considerable portion of the loan funds will generally remain on deposit with the bank.

△ If the sale and leaseback transaction is made at a figure greater than the book value, the increase in capital thus created will enable the bank to correspondingly increase its lending limit to any one borrower.

The earnings from the additional $6,000,000 of loans can generate up to $300,000 of pre-tax income. From this $300,000 income we deduct $50,000 as the debt service cost of the sale-leaseback transaction, leaving a possible $250,000 of pre-tax income. Let us reduce this to $200,000 and assume that the after tax income is $100,000. An analysis of bank earnings shows that a bank will on an average earn about 10% on capital after taxes. If we apply this average to the increased capital generated, we have after tax earnings of $100,000. Let us reduce this further to $75,000, which might be considered conservative particularly when we consider that the added volume can be handled with only a slight increase in operating expenses. There may be a slight additional advantage in that some taxes can be saved by a somewhat larger sum to be charged to reserve for bad debts account.

Generally, the stock of a well managed bank will sell at about 20 times earnings. Therefore, the result of the sale-leaseback transaction can create an additional value of $1,500,000 to the common stock outstanding.

There is still a further advantage. If the bank's earnings position is thus improved, and if the bank can utilize more capital funds to support its growth or expansion program, its added strength from the sale-leaseback transaction may enable it to procure additional senior debt

financing, at lesser cost and in greater amounts, and all without diluting the interests of the common stockholders.

CONCLUSION

What is set out above gives a review of a new approach in considering the capital structure of the bank and shows how capital requirements can be increased by the method of sale and leaseback. Within the space allotted, we hope that enough has been shown to demonstrate the feasibility of this method and how a bank may profitably consider its employment.

D. Ex. 15

ROSE, MEEK, HOUSE, BARRON, NASH & WILLIAMSON
ATTORNEYS AT LAW
720 WEST THIRD STREET
LITTLE ROCK, ARKANSAS 72201

September 8, 1967

Worthen Bank and Trust Company
401 Main Street
Little Rock, Arkansas

Re: Lease

Gentlemen:

You have requested our opinion concerning the ramifications of a long term lease with an institutional investor for the building to be constructed. The following is my understanding of the proposed lease arrangement:

It is proposed that the land will be purchased from the Urban Renewal Administration at a cost of approximately $1,450,000.00.A multi-story building (hereinafter referred to as "tower") and a multi-story parking deck will be constructed on the sight.

The institutional investor will purchase the land under the tower and construct the tower. Worthen Bank and Trust Company will purchase the land under the parking deck and construct the parking deck.

The cost of the land under the tower will be $965,000.00 and the cost of constructing the tower will be approximately $6,500,000.00.

The institutional investor proposes to enter into a "net" lease with Worthen Bank with respect to the ground under the tower and the tower. The initial term of the lease will be thirty years, with renewal options up to a total of seventy-five years. The annual rental during the initial

term of the lease will be approximately $585,000.00. Worthen Bank will be given an option to purchase the building at the end of the fifteen years at a purchase price which to thought to be in the amount of approximately $4,770,000.00. The option to purchase may also be exercisable in later years, at a reduced amount. The annual rental during the renewal periods will range from $225,000.00 per annum, during the first renewal period, to $75,000.00 per annum during the last renewal period. It is my understanding that Worthen will have no obligation to renew the lease at the end of the respective initial or renewal periods.

The problems to be considered by this letter are as follows:

1. Will the lease be recognized as a valid lease for Federal income tax purposes?

2. If the lease is not recognized as a valid lease what are the tax consequences to Worthen?

3. If the lease is recognized as a lease, will the entire annual rental be deductible, or will Worthen be required to amortize the total cost of the initial term plus renewal terms of the lease evenly over all terms?

4. May Worthen obtain the benefit of the Federal income tax "investment credit"?

5. May the Arkansas sales and use tax with respect to the construction material be avoided if the institutional investor furnishes the interim construction financing as well as the permanent financing?

6. May Worthen deduct the real estate tax on the building for purposes of the ad valorem tax?

It is my opinion that the lease will be recognized as a valid lease for Federal income tax purposes; and particularly so if the institutional investor finances the con-

struction so that there is not a sale followed by a leaseback. The classification of a lease contract, which contains a purchase option, as a "lease", rather than a sale, or a mortgage transaction, is a question of the "intention of the parties as evidenced by the written agreement read in the light of attendant facts and circumstances existing at the time the agreement was made." *D. M. Haggard*, 24 T.C. 1124 (1955) affd. per curiam 241 Fed. 288. The question is basically one of "economic reality," with a finding of a sale or mortgage rather than a lease being warranted if any one of the following factors are present:

(1) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee,

(2) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make.

(3) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.

(4) The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.

(5) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

(6) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest. (Rev. Ruling 55-540, C.B., 1955-2, 39)

Applying the above test to the present situation, I am certain that the lease will be drawn in such a way as to avoid any reference to Worthen obtaining an "equity", or paying interest. Since the renewal will be at the option of Worthen, and since the purchase option at the expiration of the thirty year term will represent a substantial investment, Worthen will not acquire title upon payment of rentals which it is required to make. The rental payments appear to be the fair rental value. Moreover, and most important, the option price will be substantially equal to the fair market value of the land and building at the time of its exercise.

Two Federal court cases have validated a "lease" where there is a substantial payment required in connection with the exercise of the option.

In the case of *Breece Veneer and Panel Company* v. *Commissioner*, 232 F. 2d. 319 (1956), the R.F.C. leased a building to the taxpayer for a five year period at an annual rental of $20,000.00 per year, with the option to renew for three additional one year periods under similar terms. The lessee was given an option to purchase after five years for $50,000.00, and after the seventh year for $37,500.00, and after the eighth year for $25,000.00. The R. F. C. and the taxpayer had previously negotiated for the sale of the building with the taxpayer offering $100,000.00. The taxpayer exercised his option to purchase the land at a cost of $48,050.00. The Tax Court had relied upon the analogy of a conditional sales contract, which had been successful for it in connection with the lease of equipment and other personal property with option to purchase, in finding that the arrangement was in fact a sale rather than a lease. The Circuit Court of Appeals distinguished this case from the

other conditional sales contract cases on the basis that the taxpayer is required to make a substantial payment in addition to the lease payments in order to obtain an equity in the property. The Court concluded that since the rental which the taxpayer was required to pay was not substantially equal to the value of the goods, the arrangement was that of a lease.

In the *District Court case of Arkansas Bank and Trust Company* v. *United States*, 224 Fed. Supp. 171 (1963) the taxpayer entered into a lease with an option to purchase which the Court recognized as a valid lease and not a sale. In that case, Arkansas Bank and Trust Company, Hot Springs, Arkansas, which had just been acquired by Cecil Cupp, proposed to build a new building. However, because of its limited capital structure, it was unable to purchase the land and construct the building. It therefore entered into a lease arrangement with the option to purchase, with respect to the ground. The property which was the subject of the lease had been purchased by its owners at a cost of $125,000.00 which was allocated $25,000.00 for the land and $100,000.00 for the improvements, including a hotel and 3 one-story buildings. The bank agreed to a net lease of the ground for 15 years at a rental of $15,000.00 per year for the first 3 years, and $10,500.00 per year for the next 12 years. The bank was given an option to extend its lease for an additional 15 years at a rental of $4,200.00 per year. At any time during the renewal period the bank was given the option to purchase the property for $35,000.00. When the bank obtained possession of the property it demolished the existing facilities and erected its banking facilities at a cost of approximately $750,000.00. The Internal Revenue Service questioned the deduction for the rental payment of $15,000.00 in the first year of the lease and the income tax deficiency was paid and the claim for refund, resulting in this litigation, was filed. The Court stated that the ultimate question is whether, *at the time of the lease*, the parties intended the payments to be for the

use of the land, or whether the payments were for the purpose of acquiring an equity in the property. One factor to consider is the economic relation of the value of the property to the option price. The Court cited, with approval, the case of *Breece Veneer and Panel Company*, supra., in distinguishing this situation from the ordinary sales arrangement. Considerable testimony was taken both on the question of the rental value of the land, and on the question of the fair market value of the ground. The Court found that the rental payments were reasonable and fully deductible.

Where there is a sale followed by a leaseback with an option to purchase, the Courts have found it easier to look through the form of the sale and find that what has occurred is merely a mortgage of the property. The complete ambit of title back to the original owner reflects on the intention of the parties at the time of the transaction. In the reported Court cases, however, the leasebacks were made susceptible to a reclassification as a mortgage since they contained usual mortgage provisions, such as the payment of attorney's fees of the lessor by the lessee, assignment of rentals, and an amortization schedule specifically referring to the payment of principal and interest.

If the lease is disregarded, and the transaction treated as a sale by the institutional investor to Worthen, or as a mortgage by Worthen of its existing building to the institutional investor, then Worthen will be entitled to capitalize the cost of the building and recover the cost through depreciation over the useful life of the building. *Paul W. Frenzel*, 22 T.C.M. 1391 (1963). In addition, Worthen will be entitled to a deduction for the payment of an interest factor. If interest is separately stated and if the separately stated interest is legal, then that amount of interest will be deductible. *Commissioner* v. *Lazarus*, 101 Fed. 2d 728 (1939), affd. 308 252 (1939). Where interest is not separately stated, Courts have been granted the discretion to

allocate a portion of the payment to interest. See *Wilshire Holding Corporation* v. *Commissioner*, 252 Fed. 2d 51. Worthen will thus be entitled to an interest deduction of $450,000.00 plus depreciation of approximately $150,000.00.

Assuming that the lease is recognized as a valid lease the question still remains whether Worthen will be entitled to deduct the full amount of the rental during the initial term of the lease. Section 162 permits a deduction for a "reasonable" allowance for rent. Assuming that the rent is reasonable, Treasury Regulation 1.162-11 provides that the cost of a leasehold interest must be deducted evenly over the number of years the lease has to run. Since the rental payments under the renewal terms are less than under the initial term, the question arises as to whether rental payments must be equalized over the initial and renewal terms. However, in view of the fact that the exercise of the renewal option is *not mandatory* on Worthen, it is my opinion that the entire rental payment in the initial term may be deducted; and it will not be necessary to equalize the payments over all terms.

The Internal Revenue Service has had some success in requiring lesses to equalize rental deductions over the term of a lease; and where there is a renewal option the Internal Revenue Service has made some attempt to require an equalizing of rental payments over initial and renewal terms; but it has had success in doing so only by finding that there is a purchase rather than a lease so that the purchase is capitalized and recovered evenly through depreciation. See Revenue Ruling 60-122 C. B. 19-1, 56. In the case of *Gem, Inc.* v. *U.S.*, 192 Fed. Supp. 841, the Treasury Department attempted to require the taxpayer to equalize its deduction with respect to a plant constructed under a municipal bonding arrangement whereby at the end of the twenty year term the industry could renew the lease for a nominal amount for an additional twenty years. The Court overruled the Treasury's position on the basis that there

was no reasonable certainty that the lease would be renewed. I have previously expressed the opinion that this lease will not be recharacterized as a "purchase"; and, in view of the economic exposure, I think it is fair to conclude that there is no reasonable certainty that this lease will be renewed at the end of the initial term.

If the higher rental during the initial term of the lease is deemed to be the "cost of the lease", within the purview of Section 178 of the Internal Revenue Code, then the presumption of renewal of the lease, which is raised by that Section, might require an equalization of the rental deductions over the initial and renewal terms of the lease. However, it is my opinion that the higher rent during the initial term is not an advance rental ("cost of the lease"); and therefore that Section 178 will not be applied to this lease.

Under Treasury Regulation 1.48-4 a lessor may elect to treat the lessee as having purchased property for the purpose of "investment credit" and thereby pass the credit through to the lessee. In this manner Worthen may become entitled to the credit for purchase of new tangible personal property, including elevators and escalators, with respect to which depreciation is allowable which have a useful life of four years or more. The amount of the credit is equal to 7% of the qualified investment during the year. The qualified investment is 100% of the cost if the useful life is in excess of 8 years, 66⅔% of the cost if the useful life is 6 to 8 years, and 33⅓% of the cost if the useful life is 4 to 6 years. The amount of the credit is limited to $25,000.00 plus 50% of Worthen's liability for tax in excess of $25,000.00.

With respect to the questions of state sales tax, and deduction for ad valorem tax, a supplement to this letter will be furnished. A supplement will also be furnished with respect to the finalized agreement. If you have any questions please advise.

Very truly yours,

/s/ JOE GIROIR
C. J. Giroir, Jr.

D. Ex. 16

FINANCING METHODS

My discussion of the financing of the construction of the new building will take into consideration several plans or combinations thereof and I would like to go over these prior to discussing the results of contacts made in New York and locally with respect to the financing.

METHOD #1

Would be through the sale of convertible and/or non-convertible debentures, preferably through private placement so that the debentures would not find their way into the local market. The debentures would not improve our capital ratios if issued in amounts merely to cover construction cost and land purchase whether or not the building is carried in the banks statement or in a real estate holding company. It is doubtful that we could obtain supervisory approval for the sale of debentures in adequate amounts to finance the building in this manner. Incidentally, the advantage of convertibles over non-convertibles would be in money cost which could be as much as 1¼% depending upon the conversion price. The lower the conversion price, the larger the deferential in interest rates would be.

METHOD #2

The Second Method would be the ownership of the building and land by a wholly owned real estate holding company which would negotiate a mortgage further supported by a lease executed by Worthen Bank & Trust Co. with rentals adequate to amortize the mortgage. Probably the maximum term which could be negotiated would be thirty years and the rate would be approximately 6½% on a thirty year mortgage, which would amount to a factor of 7.59%. In other words, annual payments would amount to 7.59 times the amount borrowed. This method would enable the bank to take the depreciation and taxes as a tax write-off.

METHOD #3

The third method would be the construction of the building by the bank on the land which would be purchased with bank funds and at completion the sale of the building to an investment group at arms length with the leaseback at a fixed rental which should be in the same cost area as the mortgage arrangement. Ordinarily such arrangements provide for the rental at 50% of the original rent after 20 or 25 years and a subsequent reduction to 25% on a second renewal basis. The arrangement can also include a purchase option permitting the bank to acquire the property prior to expiration of the lease for which a premium would be paid. However, if there is such a repurchase option the bank would not be permitted to deduct the full amount of lease rental payments for tax purposes, since a portion of such rentals would be capitalized. When such an arms length transaction is made it is generally at a rental which will reimburse the owner for his full investment and would also give him a rate of return about equal to that of a mortgage. However, the income under the lesae continues during the entire term of leaseback and any renewals and at the end of that time the property belongs to the purchaser. In addition to the arms length leaseback the bank could construct the building and sell to the real estate holding company on a leaseback arrangement with the holding company arranging the mortgage financing. One advantage of this method would be keeping the construction in the banks name which would take advantage of the waiver of the 3% sales tax on materials, equipment and so forth, purchased.

METHOD #4

It is possible to arrange for a combination of the above methods and to provide means of refinancing of mortgage,

refunding of debentures and/or recapture of real estate at a price. It is the purpose of this meeting to relate these basic methods to our situation and determine the most feasible. We should keep in mind that only the sale-lease-back method would have the automatic acceptance or supervisory authorities. Any of the other methods, including combinations thereof, would require the approval of deviation from standards. It should be borne in mind that among other considerations the building should be handled in such a manner that the 3% sales tax does not apply to purchases of materials, etc.

Now I will go into conversations I have had with various mortgage brokers, investment brokers and New York Life Insurance Company with respect to handling our financing.

• • • • • • • • • •

WORTHEN BANK & TRUST COMPANY
THE BANK THAT DOES MORE FOR YOU
Inter-Office Correspondence

From: Richard F. Gates

To: Edward M. Penick

Date: August 11, 1967

Subject: Report of Trip to New York refinancing of our new bank structure.

I discussed methods of financing with Mr. Eric Schmidt, head of the real estate division of First National City Bank, and Ray O'Keefe in the same position at Chase Manhattan, calling on the mortgage bankers we had selected for contact. Following is a report of the contacts made.

White, Weld & Co., 20 Broad Street—I met with Mr. A. M. White, Mr. George Moore, Jr., Buck Remmel, and John Cervantes (real estate consultant).

1. They suggested that convertible debentures be issued in at least sufficient amount to cover purchase of the land or in lieu thereof the land be sold to an investor and leased back on a 99 year lease with an option to repurchase the land at some future date at its original sale price. They thought this might be accomplished in the area of 6% and ¾% brokerage.
2. Suggested mortgaging building through a holding company, rate not discussed.
3. Broker will need to revise Landauer's figures with respect to capitalizing income by raising the bank's sufficient amount so that the transaction will capitalize at 8%. This is a mechanical matter, but probably important in negotiating a mortgage.

I was impressed with the quality of the people I talked to and in checking them out with First National City was informed that they are quite capable in the investment financing field, but doubted their ability in the mortgage financing. This remark was made by Mr. Eric Schmidt in spite of the fact that I told him we would have an interest, all things being equal, in working with White, Weld by reason of a connection between Mr. George Moore and his son in the business.

Hubbard Westervelt & Mottelay, Inc., 60 E. 42nd Street—I met with James D. Price and senior partner, Mr. Hubbard. After checking their reputation with First National City, they rate them as excellent in their field.

1. They recommend sale and leaseback of land to a pension fund with option to buy back at anytime, probably 6¼% rate.
2. Either a conventional mortgage or a one purpose corporation to be organized by their firm. The one

purpose corporation would negotiate for funds subject to our approval, 30 year amortization with option to purchase stock in the interim or a zero balance in 30 years. In the interim, of course, a stock purchase would involve paying off the unamortized amount. They would have an over-ride amounting to quarterly advanced rental payments.

Books, Harvey & Co., 41 E. 42nd Street—Talked to Arthur Bailey, Mr. Thomas, Mr. McHugh, and several other members of the firm and was impressed with their contacts and knowledge in the field. They were given an excellent rating by First National City. Their recommendation followed closely the recommendations of the White, Weld. They emphasized that through the connection of two of their partners, who are directors in mutual savings banks, that placement might be at a more favorable price with a mutual savings bank.

New York Life Ins. Co., 51 Madison Avenue—Talked with Eugene S. Overshine and got the impression that they felt leasing problems might exist by reason of their experience in the Tower Building. Therefore, although they quoted definite terms, I inferred that perhaps these rates were based on their preconceived ideas with respect to leasing. On a conventional basis, that is a loan of 75% based on appraisal, could be made for 30 years at 6-½%. However, if we required 100% financing, the rate would be 6-¾% with no prepayment for 10 years. After the 10th year prepayments could be made at a penalty of 6-½%, on the 11th year, then each year thereafter the penalty would decline by a .3375%.

They would consider purchasing the land and leasing it back on a 99 year basis without options on the bank to recapture. Furthermore, after I returned to my hotel, he called and said that each 33 years the land would have to be reappraised and the rent raised if the appraised value

had increased, but if the appraised value decreased, there would be no concession. To me that was the crowning blow.

He asked for a ½% per year standby fee, but after some discussion said that this could be waived.

We would be required to pay all expenses incurred by them in working the loan out including legal fees.

J. Halperin & Co., Inc., 375 Park Ave.—Their discussions followed much the same pattern as the others including the recommendation that the sale of convertible debentures be included in the picture. They thought that the cost of convertible money would be at least 1% less than a straight debenture rates and that the rate would be in the area of 6-½%. I do not consider this firm of the same caliber as the top three in this memo.

Chase Manhattan Bank, 1 Chase Manhattan Plaza—Talked with Raymond O'Keefe, senior vice president—Did not obtain much information here except he offered services of Adam C. Heck, vice president and chief tax accountant, and Jess Lawrence, assistant tax expert.

Chemical New York Bank & Trust Co., 20 Pine Street—with Hugh Jones, Jr.—Without solicitation they indicated they would like to help with the interim financing and understood, of course, that First National is our principal bank and would participate with them if they so desired.

First National City Bank—Talked to Alan Peters and met new man, Bob Stokke, Dan Haskins is no longer assigned to us. We discussed our building program at some length. When I completed our other calls I returned to First National City and again discussed the entire matter with the manager of their investment division, Eric Schmidt. I have outlined Mr. Schmidt's remark with respect to the above, but he agreed that the first three names in this memo were tops in their field and would have access to

more different types of lenders than the others. First National City stated they would handle the interim financing. I explained Chemical's offer and apparently they would be glad to share the interim financing with Chemical.

I made several other calls of no consequence and feel that it is necessary to move quickly in tying down the financing for two reasons. One, with the exception of Mr. O'Keef, all those I talked to feel interest rates are headed upward and that although New York Banks' have been off in the last several weeks, most of them have heavy fall commitments. Second, I got the impression that they all felt that if we are going to start construction within 60 days, it is going to be quite a job working out the financing and other technical matters involved therewith.

RFG/mab

No. 76-624

Supreme Court, U. S.
FILED
JAN 21 1977
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1976

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

DANIEL M. FRIEDMAN,
Acting Solicitor General,

MYRON C. BAUM,
Acting Assistant Attorney General,

GARY R. ALLEN,
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Department of Justice,
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INDEX

Page

Opinions below 1

Jurisdiction 1

Question presented 2

Statutes involved 2

Statement 2

Argument 6

Conclusion 13

CITATIONS

Cases:

American National Bank of Austin v. *United States*, 421 F. 2d 442, certiorari denied, 400 U.S. 819 13

American Realty Trust v. *United States*, 498 F. 2d 1194 ..... 10, 11, 13

Commissioner v. *Duberstein*, 363 U.S. 278 ..... 10, 13

Commissioner v. *First Security Bank of Utah*, 405 U.S. 394 ..... 12, 13

Commissioner v. *H. F. Neighbors R. Co.*, 81 F. 2d 173 9-10

Cubic Corporation v. *United States*, 34 A.F.T.R. 2d 5895 12

Cubic Corporation v. *United States*, 38 A.F.T.R. 2d 5717 12

Franklin, Estate of v. *Commissioner*, 38 A.F.T.R. 2d 6164 ..... 10, 13

Frito-Lay, Inc. v. *United States*, 209 F. Supp. 886 9

Cases—continued

Page

Gregory v. *Helvering*, 293 U.S. 465 6

Helvering v. *Lazarus & Co.*, 308 U.S. 252 ....6, 7, 10

Leeds and Lippincott Co. v. *United States*, 276 F. 2d 927 10

Nelson v. *Commissioner*, 281 F. 2d 1 9

Union Planters National Bank of Memphis v. *United States*, 426 F. 2d 115, certiorari denied, 400 U.S. 827 13

Williams v. *Kirby School Dist. No. 32*, 207 Ark. 458, 181 S.W. 2d 488 9

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 163 2

Sec. 167 2

12 U.S.C. 371d 3, 12

Miscellaneous:

Federal Rules of Civil Procedure, Rule 52(a) 13

Rules of the Supreme Court of the United States, Rule 19(1)(b) 11

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OCTOBER TERM, 1976

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum letter opinion and findings of fact and conclusions of law of the district court (Pet. App. A 1a-14a) are not reported. The opinion of the court of appeals (Pet. App. B 15a-30a) is reported at 536 F. 2d 746.

JURISDICTION

The judgment of the court of appeals was entered on May 26, 1976 (Pet. App. C 31a). On August 6, 1976, the court of appeals clarified the final sentence of its opinion, but otherwise denied petitioner's petition for rehearing with suggestion for rehearing *en banc* (Pet. App. D 32a-33a). The petition for a writ of certiorari was filed on November 3, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the decision below correctly held that the sale of a building to petitioner and the long-term lease of the property back to the seller did not confer upon petitioner any significant ownership interest in the property that would entitle it to income tax deductions for mortgage interest and depreciation, where the rent paid by the seller was equal to the mortgage payments; the seller had an option to repurchase the property for the cash advanced by petitioner, plus interest, and the balance of the mortgage loan; and the seller retained a reversionary interest in the land.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

STATEMENT

This case involves the federal tax consequences of a sale and leaseback transaction in which petitioner took title to a

building under construction by the Worthen Bank & Trust Company ("Worthen") of Little Rock, Arkansas, and simultaneously leased the building back to Worthen for use as its headquarters and principal banking facility.

The pertinent facts are undisputed. Petitioner is a corporation engaged in distributing household electronic products (I-R. 20-22).[1] In 1965, the Worthen Bank purchased land in downtown Little Rock, upon which it planned to construct an office building for its headquarters (Pet. App. A 3a-4a). Worthen originally intended to finance the construction itself, and to retain title to the building. However, it was unable to obtain the requisite approval from federal banking authorities to invest an amount greater than its capital stock in the proposed new bank premises (Pet. App. B 16a). See 12 U.S.C. 371d.[2] After abandoning a second plan under which it proposed to raise the necessary funds through the issuance of debentures by a wholly-owned subsidiary, Worthen decided to seek financing through the use of a conventional mortgage coupled with a sale and leaseback arrangement with a third party. Both the Federal Reserve Bank of St. Louis and the State Bank Department approved the plan after modifications (Pet. App. A 4a; Pet. App. B 16a).

Construction of the building began on September 15, 1967. At that time, Worthen had obtained commitments from First National City Bank of New York for interim construction financing, and from New York Life Insurance Company for long-term financing, subject to their approval of the party nominated by Worthen to hold title to the building (Pet. App. B 16a). After negotiations between

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[1] "I-R." and "II-R." refer to the two volume record appendix in the court of appeals.

[2] The estimated cost of the proposed building was $9,000,000, and Worthen's outstanding capital stock was $4,000,000 (Pet. App. A 4a).

Worthen and petitioner (whose principal shareholder was a director of Worthen) and other parties. Worthen selected petitioner as the party to hold title to the building. Worthen, petitioner, and the two lenders thereupon entered a series of interrelated agreements calling for petitioner to invest $500,000 in the building, which was to bear "interest" at six percent per year, with the balance of the cost of construction to be financed by a mortgage loan to be provided by New York Life, payable over 25 years (Pet. App. B 17a).

On May 1, 1968, Worthen executed a "ground lease" covering the underlying land to petitioner for a term of 75 years, with rentals for the first 25 years in the nominal amount of $50 per year. On May 19, 1968, petitioner agreed to purchase the building, as it was being constructed, at a price equal to the construction cost (not to exceed the amount of the $7,140,000 mortgage loan to be provided by New York Life plus $500,000). By agreement dated May 1, 1968, petitioner agreed to lease the building back to Worthen for a primary term of 25 years with annual rentals exactly equal to the principal and interest payments on the New York Life mortgage (Pet. App. B 16a-17a). Worthen's obligation to pay these amounts over the primary term was absolute and unconditional. Worthen also had the obligation to pay all expenses on the property (including taxes and insurance) and continued to bear all risks of loss (Pet. App. B 20a).

The lease agreement between Worthen and petitioner further provided that Worthen retained an option to repurchase the building at the end of the 11th, 15th, 20th and 25th years of the primary term of the agreement at a price equal to the unamortized principal balance of the New York Life mortgage plus petitioner's $500,000 investment, with interest compounded at six percent per year.[3] Worthen also

[3] The Arkansas State Bank Department required that such a leaseback arrangement provide for a repurchase option at the end of the 15th year, but did not otherwise specify the terms of the agreement (Pet. App. A 4a).

had the option to extend the term of the lease for up to 40 additional years at greatly reduced rentals, which were further offset by sharply increased ground rentals due Worthen for such periods. The net amounts payable by Worthen to petitioner over this extended term would yield a return on petitioner's $500,000 investment of slightly less than six percent (Pet. App. B 17a, 19a-20a).

Pursuant to these agreements, petitioner became the formal obligor on the interim and permanent loans provided by First National City Bank and New York Life. In accordance with Worthen's express consent, the lease agreement between petitioner and Worthen was given as security for those loans (Pet. App. B 18a).

On audit of petitioner's 1969 income tax return, the Commissioner determined that petitioner was not the owner of the Worthen building but that it was acting merely as a conduit for the transmission of interest payable on these loans from Worthen to the lenders. Accordingly, he disallowed petitioner's claimed deductions for mortgage interest and depreciation, and excluded the rental payments from its income (Pet. App. A 7a-8a).

In this refund suit brought by petitioner in the United States District Court for the Eastern District of Arkansas, the district court held that petitioner was entitled to be treated as the owner of the building for purposes of claiming tax deductions for mortgage interest and depreciation (Pet. App. A 1a-14a). The court of appeals unanimously reversed (Pet. App. B 15a-30a). It concluded that the transaction was "closely akin to that in *Helvering* v. *F. & R. Lazarus & Co.*, [308 U.S. 252]" (Pet. App. B 28a) because the petitioner had no "significant ownership interest" in the building (Pet. App. B 30a). In the court of appeals' view, petitioner "served as a mere conduit for the mortgage payments made by Worthen to New York Life" and the "benefits, risks, and burdens" borne by petitioner with respect to that building

were "too insubstantial" to support its claimed status as the owner of the building (Pet. App. B 29a).[4]

ARGUMENT

I. The court of appeals correctly held that under this Court's decision in *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, the sale and leaseback transaction did not confer upon petitioner any significant ownership interest in the building that would entitle petitioner to income tax deductions for mortgage interest and depreciation. In *Lazarus*, this Court unanimously held that the taxpayer could disregard the form of a sale and leaseback transaction where the economic benefits and burdens of ownership were retained by the purported seller-lessee, whose payment of "rentals" simply served to amortize the mortgage loan on the property. Thus, the Court permitted the seller-lessee to claim depreciation deductions on real property nominally titled in the lessor. Here, in a transaction that the court of appeals recognized to be "closely akin" (Pet. App. B 28a) to that in *Lazarus*, the decision below properly permitted the Commissioner likewise to disregard the form in favor of the economic substance of the arrangement and to disallow petitioner's claimed interest and depreciation deductions. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465.

As in *Lazarus*, the nominal seller of the property remained in possession of the premises and paid rentals calculated to provide a fixed return on the purported purchaser's investment. The "rental" payments made by Worthen exactly equaled petitioner's principal and interest payments on the New York Life mortgage (Pet. App. B 19a). Moreover, Worthen had an absolute obligation to make the

[4]On petitioner's petition for rehearing, the court of appeals modified its opinion to provide for a remand to the district court for further findings with respect to its claimed deductions for interest on the interim construction loan and for miscellaneous additional expenses in connection with these agreements (Pet. App. D 32a-33a).

rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding (Pet. App. B 18a). Indeed, it was impossible for Worthen to terminate the arrangement because it expressly consented to the assignment of petitioner's interest in the lease as security for the loan.

Thus, Worthen's role in the transaction was identical to a mortgage debtor who has an absolute obligation to make payments to the mortgage lender over the life of the mortgage. In substance, Worthen mortgaged the building; petitioner's role in the transaction was simply that of a conduit to foward Worthen's mortgage payments, cast in the form of "rentals," to the mortgagee, New York Life. Under these circumstances, petitioner is not entitled to deductions for mortgage interest and depreciation because it had no ownership interst in the property.

Moreover, the repurchase options retained by Worthen further demonstrate that petitioner did not bear any of the benefits and burdens of ownership. Here, as in *Lazarus*, the purported seller-lessee (Worthen) had the option to repurchase the property for an amount equal to the unpaid mortgage balance and petitioner's investment, plus interest (see Pet. App. B 19a).[5] At stated intervals during the term of the agreement, Worthen could have stepped into the shoes of petitioner and acquired title to the building simply by assuming the mortgage and repaying petitioner's $500,000 investment plus interest. Since petitioner did not stand to benefit from any appreciation in the value of the building or

[5]Contrary to the district court's "finding" (Pet. App. A 6a) that the option prices represent the parties' "negotiated estimate * * * as to the fair market value of the building on the option dates," the record shows that these prices were geared precisely to the principal balance of the New York Life loan and the return of petitioner's $500,000 at the proposed "interest" rate of 6 percent (Pl. Ex. 13).

stand to suffer any loss from any decrease in its value, it did not own the building in any realistic sense of the word.[6]

Petitioner (Pet. 7, 15) seeks to minimize the significance of the option to repurchase by citing the district court's finding (Pet. App. A 6a) that it was unlikely that Worthen would exercise the option. But as the court of appeals correctly recognized (Pet. App. B 19a), the reason why Worthen might not exercise its option to repurchase at the end of the primary term, if not before, is that it had the right to occupy the building for an additional 40 years, retaining all of the benefits of ownership, at drastically reduced rentals, which would repay petitioner its $500,000 investment with a return of slightly *less* than six percent compounded interest. Moreover, since Worthen retained title to the underlying land, it was assured, in any event, of

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[6]Petitioner argues (Pet. 15-16) that it was not totally deprived of the prospect of realizing any appreciation on the building because the depreciation deduction would reduce its adjusted basis in the property so that it would enjoy taxable "appreciation" on its recovery of its $500,000 with interest on the exercise of an option by Worthen. But this argument assumes that petitioner is entitled to claim depreciation deductions, the very question at issue in the case. Moreover, such tax "appreciation" would have no relationship to the economic appreciation in the value of the building itself, because petitioner's return, on the exercise of Worthen's option, would never exceed a fixed return of 6 percent on its investment.

Petitioner also argues (Pet. 16) that it could have sold the building at a profit to third parties. But petitioner obviously could not sell the underlying land, and any sale of its interest in the building would be subject to the rights of Worthen. Hence, any profit on such a transaction would reflect appreciation in the value of petitioner's rights under the lease, and not the building itself. Finally, petitioner suggests (Pet. 16) that it would realize any appreciation on the destruction or condemnation of the property. In fact, the lease required petitioner to pay over any insurance or condemnation proceeds to Worthen as necessary to restore or replace the property. In the case of total destruction or taking after December 1, 1980, Worthen had the option either to replace or to repurchase the property at a price computed on the same basis as its outright repurchase options (Pl. Ex. 19, sec. 17).

recovering absolute possession and ownership of the property on the expiration of the ground lease a relatively short time after the end of the extended term of the building lease.[7] Cf. *Frito-Lay, Inc.* v. *United States*, 209 F. Supp. 886 (N.D. Ga.).

If, as the court of appeals noted (Pet. App. B 24a), the various obligations and rights of ownership are analogized to a "bundle of sticks," it is clear that Worthen held most, if not all, of the "sticks" and petitioner few or none. Since it is virtually inconceivable that Worthen would simply walk away from its investment in this building at the end of 25 years after it had fully paid for its construction (except for the return of petitioner's $500,000 investment), the only risk borne by petitioner was that Worthen would become insolvent. But that is nothing more than the risk which would be borne by the guarantor of a loan rather than the owner of real property. The court of appeals therefore correctly held that Worthen, and not petitioner, was the actual owner of the building and that petitioner was simply a conduit between Worthen and New York Life.[8] Accordingly, Worthen and not petitioner is entitled to claim deductions for mortgage interest and depreciation with respect to the building.[9] Accord: *Commissioner* v. *H. F.*

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[7]Contrary to petitioner's assertion (Pet. 16), the law of Arkansas is in accord with the general common law rule that, unless the parties agree otherwise, improvements to real estate made by the lessee return to the owner of the land on the expiration of the lease. *Williams* v. *Kirby School Dist. No. 32*, 207 Ark. 458, 181 S.W. 2d 488, 490.

[8]The mere fact that such payments were made through petitioner does not serve to allow it to deduct such amounts, when the loan was in actuality made for the benefit of Worthen. Cf. *Nelson* v. *Commissioner*, 281 F. 2d 1 (C.A. 5).

[9]Contrary to petitioner's assertion (Pet. 11), the denial of the depreciation and interest deductions is not "to catch [it] in a trap, and to give Worthen a windfall * * *." While the parties may have expected to receive certain tax treatment, that expectation hardly requires the

Neighbors R. Co., 81 F. 2d 173 (C.A. 6); *Leeds and Lippincott Co.* v. *United States*, 276 F. 2d 927 (C.A. 3); *Estate of Franklin* v. *Commissioner*, 38 A.F.T.R. 2d 6164 (C.A. 9).[10]

2. Contrary to petitioner's further argument (Pet. 8, 12), the decision below does not conflict with *American Realty Trust* v. *United States*, 498 F. 2d 1194 (C.A. 4). There, as here, the court of appeals examined the transaction in the light of the controlling legal standard established by this Court's decision in *Helvering* v. *Lazarus & Co., supra.* However, it concluded that the details of the arrangement were "sufficiently distinguishable from those in *Lazarus*" (*id.* at 1199). It therefore held that there was sufficient evidence to support a jury verdict that the purchaser-lessor in a sale and leaseback transaction had an ownership interest in the property so as to be entitled to include the rental payments in its income and deduct the mortgage interest and depreciation, and to qualify as a real estate investment trust. Here, the court of appeals like-

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Commissioner to adhere to the form rather than the substance of the transaction. See *Commissioner* v. *Duberstein*, 363 U.S. 278, 286. At all events, the denial of the deductions to petitioner will be mitigated by the exclusion of the "rentals" from its gross income. Likewise, whatever benefit Worthen received from depreciation will be ultimately offset by the disallowance of its "rental" payments, except to the extent they represent interest required to be paid to New York Life.

[10]Petitioner suggests (Pet. 10-11) that it should make no difference to the government whether it or Worthen claims the interest and depreciation deductions as long as both parties do not claim the same deductions. But the Commissioner is required to tax such transactions in accordance with their actual economic substance and not the formal labels adopted by the parties. While there may be particular instances in which an audit of both parties to a sale and leaseback transaction does not result in the collection of additional revenues, differences in the tax characteristics of the parties (*e.g.*, tax bracket, taxable status) may produce net deficiencies.

wise refrained from making a "general condemnation of sale-leaseback arrangements" (Pet. App. B 30a). But on the facts of this case, it held that "[t]he overall nature of this transaction is closely akin to that in [*Lazarus*]" (Pet. App. B 28a).

While both *American Realty Trust* and the decision below involve sale and leaseback transactions, the two cases are sufficiently distinguishable on their facts so that the differing results do not create a conflict "on the same matter" within the meaning of Rule 19(1)(b) of the Rules of this Court.

Unlike this case, it does not appear that the rental payments in *American Realty Trust* were precisely equal to the principal and interest payments on the underlying mortgage so as to establish the conduit role of the lessor that exists here. Indeed, the agreement in that case provided that the rent was to be reduced by only 50 percent of the reduction in the mortgage payments. Moreover, the agreement in *American Realty Trust* personally bound the seller-lessee to pay the rent only for the first six years of the 21-year lease and permitted him to assign the lease thereafter (see 498 F. 2d at 1195). Here, however, Worthen had an absolute obligation to make the rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding. There was accordingly no realistic possibility that petitioner would bear the risks of the rental market for the building.

Finally, unlike this case where Worthen could acquire title to the property either by exercising the repurchase option or by means of its reversionary interest, the lessee in *American Realty Trust* could only acquire title through the repurchase option. There, the court held that there was testimony tending to show that the lessee exercised his repurchase option "because of the sudden availability of 'wrap-around' financing, not because there was any 'economic compulsion' to repurchase inherent in the deal" (*id.* at 1199). Given these distinguishing characteristics, the

court of appeals in this case correctly concluded that "[t]he arrangement * * * [in *American Realty Trust*] was not nearly so thin and transparent as the present transaction" (Pet. App. B 29a).[11]

3. Petitioner further argues (Pet. 9) that the decision below is contrary to the "essence of this Court's decision in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394." In *First Security Bank*, this Court held that the Commissioner could not exercise his authority under Section 482 of the Code to allocate insurance commissions to the taxpayer when it was prohibited by federal banking law from earning such commissions. Petitioner contends that Worthen cannot be deemed to be the owner of the building and the borrower of the money because it could not legally borrow the money. However, this case does not involve the conflict between the Commissioner's power to allocate income and federal or state restrictions on receipt of income considered in *First Security Bank*. But assuming *arguendo* that the banking law to which Worthen was subject might be relevant in determining the tax consequences of this transaction to petitioner (cf. Pet. App. B 30a), the federal banking law did not prohibit Worthen from borrowing the money but simply required it to seek the approval of the regulatory authorities before making an investment in bank premises in an amount greater than its outstanding capital stock. See 12 U.S.C. 371d. Since the federal and state banking authorities approved the sale and

[11]Petitioner also argues (Pet. 9, 13) that the decision below conflicts with *Cubic Corporation* v. *United States*, 38 A.F.T.R. 2d 5717 (C.A. 9). That case did not involve a sale and leaseback transaction. There, the court held that a particular lease-option agreement for machinery was not a conditional sale where the agreement specifically provided that it should not be construed as a conditional sale contract and there was no evidence as to the fair market value of the machinery or of the option. See *Cubic Corporation* v. *United States*, 34 A.F.T.R. 2d 5895, 5897 (S.D. Cal.).

leaseback transaction (see Pet. App. A 4a), the rule of *First Security Bank* is inapplicable here.

4. Finally, petitioner contends (Pet. 14-17) that the court of appeals improperly reversed the district court's decision in its favor because the "clearly erroneous" standard of Fed. R. Civ. P. 52(a) protected the district court's finding that the parties intended the transaction to be a sale and leaseback with option to repurchase (see Pet. App. A 2a). See also *Commissioner* v. *Duberstein*, 363 U.S. 278. But the court of appeals did not dispute the district court's finding as to the intent of the parties. It therefore did not violate the "clearly erroneous" rule of Rule 52(a). Rather, the court of appeals concluded, as a matter of law, that the agreement was "simply too insubstantial to establish [petitioner's] * * * claim to the status of owner for tax purposes" (Pet. App. B 29a). In this respect, its decision is in accord with the other courts of appeals which have held that the question whether such agreements are the sales or financing transactions is one of law. *American Realty Trust* v. *United States, supra*, 498 F. 2d at 1198; *Estate of Franklin* v. *Commissioner, supra*, 38 A.F.T.R. 2d at 6165, n. 3; *American National Bank of Austin* v. *United States*, 421 F. 2d 442, 451 (C.A. 5), certiorari denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States*, 426 F. 2d 115, 117-118 (C.A. 6), certiorari denied, 400 U.S. 827.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY MEMORANDUM FOR THE PETITIONER

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REPLY MEMORANDUM FOR THE PETITIONER

This reply to the Government's brief in opposition is filed because the Government has failed to face the important issues of equity, tax administration, and precedent presented by the decision below.

1. The principal difficulty with the position of the Government, and the approach of the court of appeals,

is the failure to recognize that taxpayers must plan, and that the Internal Revenue Service should tax such transactions in a fashion which is at least roughly predictable. On the practical as well as the conceptual level, it is proper that this transaction should be taxed as the parties understood it.

On the most simple common-sense level, the taxpayer and Worthen both had substantial and legitimate nontax motives for entering into the transaction and organizing it as they did.[1] They planned in good faith for certain consequences and bargained at arms length on those assumptions. And there is no practical reason not to tax the transaction as it was planned and structured. There is no revenue difference—corporate rates are flat rates and the Government will get the same tax from the petitioner, under its contention, as it would get from Worthen under the Government's contention. The Government's position is primarily formal—to no practical avail—while completely upsetting the reasonable expectations of the parties.

The Ninth Circuit in *Cubic Corporation* v. *United States,* 541 F.2d 829, recognized that the intention and situation of the parties should be a substantial factor in determining tax consequences; there should, in short, be some reason for upsetting good faith tax planning untainted by sham. The Government attempts to distinguish *Cubic* by pointing out that *Cubic* did not involve a sale and leaseback. But the Government fails to show any reason why the intent of the parties should be important in determining whether there was a "sale" in *Cubic* and yet irrelevant here. *See also*

[1] For instance, the terms of the agreement were formed to meet requirements of banking law, and by the competition among bidders.

American Realty Trust v. *United States,* 498 F.2d 1194, 1198-99 (4th Cir. 1974).[2]

2. There is no indication in the Government's brief of how the uncertain "bundle of sticks" approach adopted by the court below can be reliably or predictably used to discern the "economic substance" of a transaction.

In two footnotes (Brief in Opposition at 9-10, nn. 9, 10), the Government dismisses all consideration of predictability in general and fairness to the particular parties, observing that tax consequences must follow "economic substance." But here significant aspects of the "substance" of the transaction are given little or no weight. The Lyon-Worthen agreement was an *arms-length transaction* between two commercial actors, there was no *differential in tax rate* between the two parties, and both had *substantial nontax reasons* for entering into the transaction in its present form. Although there is no contention that the transaction is a "sham," or that tax avoidance was the objective or the result, the bargain is scrambled and the expectations of the parties frustrated.

3. The Government's position is that the Frank Lyon Company's share of the benefits and burdens of ownership is simply insufficient to allow it to take depreciation deductions.

[2] Earlier cases have likewise emphasized the importance of the intent of the parties in determining the "economic substance" of the transaction involved. *See, e.g., Helvering* v. *Lazarus & Co.,* 308 U.S. 252 (1939); *Western Contracting Corporation* v. *Commissioner,* 271 F.2d 694 (8th Cir. 1959); *Oesterreich* v. *Commissioner,* 226 F.2d 798, 801-802 (9th Cir. 1955); *Commissioner* v. *H. F. Neighbors Realty Co.,* 81 F.2d 173 (9th Cir. 1936).

The factual difficulties with this conclusion are outlined in the Petition at 15-16 and throughout the opinion of the district court. Pet. App. A. It is illustrative to note that the Government has made no attempt to explain away the 10-year period between the end of the building lease and the end of the ground lease.[3] During this period, Lyon was at liberty to use or rent the property as it wished while paying the specified ground rental of $10,000 per year. This residual interest makes it clear that petitioner was not a mere "conduit" for loan money as the Government and the court of appeals have asserted.[4]

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[3] By citing this fact, petitioner does not, of course, accept the Government's characterization of the other burdens and benefits retained by Lyon. This terminal period is merely the clearest example of the Government's refusal to recognize any part of the "substance" of the transaction which does not comport with its own conceptualizations.

[4] The Government relies in its Brief in Opposition far more heavily on Worthen's reversionary interest in the building than did the court of appeals. In its statement of the question presented and in its discussion of *American Realty Trust, supra*, the Government states as fact its conclusion on reversion, though it is a disputed question of Arkansas law which the court of appeals stated that it "need not resolve". Pet. App. 27a, n.6. This question, too, materially affects the "conduit" theory on which the Government's case depends.

The common law rule cited by the Government—that improvements by a lessee revert to the owner at the end of the lease unless the lease provides otherwise—does not deal with the more complicated situation presented here, where the ground lessor has *sold* the improvement to the lessee without any reservation of reversionary rights.

Arkansas law clearly recognizes that one person may own the leased land and another may own the improvements thereon. In *Stirman* v. *Craven*, 33 Ark. 376 (1878), the Arkansas Supreme Court resolved the dilemna of dual ownership of the land and building after the termination of the lease by ordering the property sold and the purchase price divided in proportion to value. *Stirman* followed an earlier case, *Witherspoon and Gilliam* v. *Nichols, Sheriff*, 27 Ark. 332 (1871), was cited with approval in *Butler* v. *Adder—Goldman Commission Company*, 62 Ark. 445, 450, 35 S. W. 1110, 1111 (1896), and in *Storthz* v. *Sanger*, 108 Ark. 154, 161, 156 S. W. 1020, 1122 (1913) and has never been overruled or questioned.

Where the Government does attempt to meet the petitioners' arguments concerning the burdens and benefits of ownership which petitioner bears under the arrangement, its position ignores the practicalities of the situation. Thus, when petitioner points to the fact that it could have sold the building at a profit (Pet. at 16) the Government does not dispute the fact, it merely concludes that, since petitioner could not sell the land, sale profit would reflect appreciation of lease rights and not the building itself. (Brief in Opposition at 8, n.6). This hypertechnical distinction not only ignores rights beyond lease rights which would be conveyed (the right to resale and the other burdens and benefits of ownership which the petitioner points out in its brief), it fails totally to reconcile any appreciation on a sale with its "conduit" theory of petitioner's participation.

In a similar manner, the Government argues that petitioner could not realize any profit or loss on condemnation of the building because the lease required that petitioner pay over to Worthen the amount necessary to restore or replace the leasehold. (Brief in Opposition at 8, n.6). This argument ignores the possibility that the amount necessary to restore or replace the leasehold property may not be the same as the amount of insurance or condemnation proceeds.

Finally, the Government asserts that the risk of Worthen's insolvency is no different than the risk faced

by the guarantor of a loan. (Brief in Opposition at 9). This does not mean that the risk is not a risk of ownership. Nor does this argument deal with the possible opportunity presented by a Worthen insolvency if insolvency leaves the petitioner free to deal with a building that has appreciated in value free of the lease.

Moreover, the conclusion that Lyon was a mere conduit, and the factual determinations and assessment which support that conclusion, were fully rejected by the district court as trier of fact. (See Pet. App. A; Pet. at 7.) The district court found that the option prices represented a "negotiated estimate . . . as to fair market value of the building," but the Government simply rejects this finding. (Brief in Opposition at 7.) The Government is asserting that it understands the dynamics of the negotiation better than the trier of fact, and rejecting the plausible conclusion that the terms were what they were because competition for the investment opportunity put Worthen in a position to demand the terms on which the parties agreed. Pet. at 7; Pet. App. A 13a, 10a.

4. A full appreciation of the facts is necessary to determine the "economic substance" of a transaction. The Government's position—that "economic substance" can and should be determined as a pure matter of law—is a dangerous misreading of the law.

The cases cited by the Government (Brief in Opposition at 13) can be taken as supporting the proposition that when the facts are established the determination of the question whether such agreements are to be taxed as sales or financing transactions is ultimately a legal conclusion. The cases cited do not support the idea that courts of appeals should determine the

facts *de novo* in utter disregard of the findings of the trier of fact; yet this is what the Government seeks here, because in *Lyon,* the findings of the district court upheld the taxpayer at every point.

Although the Government cites *American Realty Trust* v. *United States,* 498 F.2d 1194 (4th Cir. 1974), for instance, the *American Realty Trust* court dealt only in the alternative with the Government's contention that a sale-leaseback could be dealt with *de novo* as a matter of law. The court had declared itself "disinclined to disturb the jury's verdict" since there was enough supporting evidence to preclude a conclusion that the verdict on the sale or financing arrangement question was clearly erroneous. 498 F.2d 1198. The ultimate conclusion may be legal but it must be "grounded in underlying findings of fact." 498 F.2d at 1198.

The *American Realty Trust* court's treatment of the issue as a whole, with its full recognition of the importance of the factual findings and the intent of the parties, provides sharp contrast to the decision of the court of appeals here, and the approach the Government urges on this Court. The two approaches, with their conflicting signals to tax planners, cannot be reconciled except by this Court.

5. In its discussion of this Court's decision in *Commissioner* v. *First Security Bank of Utah,* 405 U.S. 394, the Government has simply scrambled what went on when this transaction was carried out. It says (Brief in Opposition 12-13): "Since the federal and state banking authorities approved the sale and leaseback transaction (*See* Pet. App. A 4a), the rule of *First Security Bank* is inapplicable here."

Yet, it is entirely clear that both federal and state banking authorities refused to approve an arrangement under which Worthen would be the owner of the building.[5] It was because of this that Worthen decided to sell the building to the petitioner, and then to lease it back. It is true that the state and federal banking authorities approved this transaction; but the very reason that they did so was because Worthen was *not* the owner of the building under the agreement between the parties. To say that the petitioner should now be taxed as if Worthen was the owner of the building, and that "*First Security Bank* is inapplicable here" is to stand the transaction on its head. What the banking authorities approved was an arrangement in which Worthen was the lessee. This was the view of the court of appeals. Pet App. 16a. For the Government now to say that "The Federal banking law does not prohibit Worthen from borrowing the money but simply required it to seek the approval of the regulatory authorities" (Brief in Opposition 12), when the Federal banking authorities had expressly disapproved an arrangement under which Worthen borrowed the money and was the owner of the building, is disingenuous.

[5] In footnote 3, page 4, of its Brief in Opposition, the Government erroneously stated that the State Bank Department required a repurchase option at the end of the 15th year of the lease, "but did not otherwise specify the terms of the agreement." It is questionable whether the State Bank Department would have approved an option price at fair market value rather than an agreed upon "figure" or dollar amount.

CONCLUSION

The Government has failed here, as the court of appeals failed below, to reconcile the decision below with the findings of the district court, with applicable precedent, or with the dictates of practical foreseeability and sound tax administration. In order to provide badly needed clarity in this field, the Court should grant the petition for certiorari.

Respectfully submitted,

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No. 76-624

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

FRANK LYON COMPANY, *Petitioner*

v.

THE UNITED STATES, *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

BRIEF FOR THE PETITIONER

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TABLE OF CONTENTS

	Page
TABLE OF CONTENTS	i
TABLE OF AUTHORITIES	ii
OPINIONS BELOW	1
JURISDICTION	1
QUESTIONS PRESENTED	2
STATUTE INVOLVED	2
STATEMENT	3
SUMMARY OF ARGUMENT	12
ARGUMENT	
I. THE TRANSACTION SHOULD BE TAXED AS IT WAS STRUCTURED BY THE PARTIES—AS A BONA FIDE SALE AND LEASEBACK	15
II. THERE IS NO BASIS FOR DISALLOWING THE DEDUCTION OF INTEREST WHICH LYON PAID ON MONEY IT BORROWED	24
III. CONSIDERATIONS OF TAX "SUBSTANCE" SUPPORT LYON'S CLAIM TO THE DEDUCTION OF DEPRECIATION, INTEREST, AND EXPENSES	26
A. Under the Agreement, Lyon is the Party Most Likely to Sustain the Burden of Depreciation in the Value of the Building Through "Wear and Tear" or "Obsolesence"	26
1. Option Prices and Rentals	28
2. The 25-Year Breakpoint	30
B. The Spurious Nature of the Commissioner's Action Is Clearly Shown by the Inclusion in Lyon's Income of Imputed "Interest" From Worthen	34

Page

C. The Government's "Conduit" Theory of the Loan Payments to the New York Life Insurance Company Is Inconsistent With the Legal Obligations of the Parties, With a Practical Construction of the Effect of Those Obligations, and With This Court's Decision in Commissioner v. Brown 37

D. Commissioner v. First Security Bank of Utah, Precludes a Finding That Worthen Owns the Bank Building for Tax Purposes 44

IV. The Transaction Should Be Taxed In Accordance With The Detailed Factual Findings Of The District Court 46

Conclusion 55

TABLE OF AUTHORITIES

Cases: Page

American Realty Trust v. *United States*, 498 F.2d 1194 (4th Cir. 1974) 13, 14, 19, 49, 51-53
Arkansas Bank & Trust Co. v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963) 19
Benjamin Levinson, 45 T.C. 380 (1966) 22
Benton v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952) 18-19
Breece Veneer & Panel Co. v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956) 19
Butler v. *Adler-Goldman Commission Company*, 62 Ark. 445, 35 S.W. 1110 (1896) 43
Carl L. Danielson, 50 T.C. 782 (1968) 22
Commissioner v. *Brown*, 380 U.S. 563 (1965) 13, 37-39
Commissioner v. *Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) 22
Commissioner v. *Duberstein*, 363 U.S. 278 (1960) ..49, 51, 53
Commissioner v. *First Security Bank of Utah*, 405 U.S. 394 (1972) 14, 44-45
Cubic Corporation v. *United States*, 541 F.2d 829 (9th Cir. 1976) 19
First Agricultural National Bank v. *State Tax Commission*, 392 U.S. 339 (1968) 7

Page

Gregory v. *Helvering*, 293 U.S. 465 (1935) 15
Helvering v. *Lazarus & Co.*, 308 U.S. 252 (1939) 13,19, 27, 50-51
Horton v. *United States Steel Corp.*, 286 F.2d 710 (5th Cir. 1961) 53
Journal-Tribune Publishing Co. v. *Commissioner*, 348 F.2d 266 (8th Cir. 1965) 28
Kearney & Trecker Corp. v. *United States*, 195 F. Supp. 158 (E.D. Wisc. 1961) 19, 49
Knetsch v. *United States*, 364 U.S. 361 (1960) 16
Lockhart Leasing Co. v. *United States*, 446 F.2d 269 (10th Cir. 1971) 51
Lundgren v. *Freeman*, 307 F.2d 104 (9th Cir. 1962) ... 53
Meiselman v. *Commissioner*, 300 F.2d 666 (4th Cir. 1962) 19
National Carbide Corp. v. *Commissioner*, 336 U.S. 422 (1949) 25
Northwest Acceptance Corp., 58 T.C. 836 (1972) *aff'd* 500 F.2d 1222 (9th Cir. 1974) 30, 49, 50-51, 53
Oesterreich v. *Commissioner*, 226 F.2d 798 (9th Cir. 1955) 19
Reade Manufacturing Co., 32 T.C.M. 1225 (1973) 19, 50
Spring City Foundry Co. v. *Commissioner*, 292 U.S. 182 (1934) 35
Stirman v. *Cravens*, 33 Ark. 376 (1878) 42-43
Storthz v. *Sanger*, 108 Ark. 154, 156 S.W. 1020 (1913) . 43
United States v. *Anderson*, 269 U.S. 422 (1926) 35
United States v. *Singer Manufacturing Co.*, 374 U.S. 174 (1963) 53
United States v. *United States Gypsum Co.*, 333 U.S. 364 (1948) 53
Van Zandt v. *Commissioner*, 341 F.2d 440 (5th Cir. 1965) 17
Western Contracting Corp. v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959) 19
Williams v. *Kirby School District No. 32*, 207 Ark. 458, 181 S.W. 2d 488 (1944) 42
Witherspoon v. *Nickels*, 27 Ark. 332 (1871) 43
World Publishing Co. v. *Commissioner*, 299 F.2d 614 (8th Cir. 1962) 22-23

Page

STATUTES AND REGULATIONS:

Income Tax Regulations:

§ 1.167(a)-4 28
§ 1.446-1(c)(ii) 35
Int. Rev. Code, § 48(d) 27
Int. Rev. Code, § 163(a) 2, 24
Int. Rev. Code, § 167(a) 2, 27
Int. Rev. Code, § 178 28
Int. Rev. Code, § 482 45
Fed. R. Civ. P. 52(a) 50, 53

OTHER AUTHORITIES:

1966-2 Cum. Bull. 5 22
Lefevre, "The Tax Law of Lease Transactions Revisited" 53 *Taxes* 764 (1975) 20
9 Wright & Miller, Federal Practice & Procedure §§ 2587, 2589 (1971) 53

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 536 F.2d 246, and is reproduced in the appendix to the petition for certiorari as appendix B (Pet. App. pp. 15a-30a). The memorandum opinion, findings of fact and conclusions of law of the district court, as supplemented, are not reported; they are set forth as appendix A to the petition for certiorari (Pet. App. pp. 1a-14a).

JURISDICTION

The judgment below was entered on May 26, 1976 (Pet. App. C, p. 31a). On August 6, 1976, the court

of appeals denied a timely petition for rehearing (Pet. App. D, pp. 32a-33a). The petition for certiorari was filed November 3, 1976, and the petition was granted on February 22, 1977. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the petitioner was entitled, as owner-lessor of a building, to deduct on its Federal income tax returns depreciation with respect to that building, and interest and expenses which it paid in connection with loans on which it was liable.

2. Whether the court of appeals erred in setting aside the factual and legal judgment of the district court that the petitioner was entitled to the interest and depreciation deductions, on the basis of the court of appeals' own conclusion that the "cumulative effect" of otherwise ordinary lease features rendered the ownership interest of Lyon "too unsubstantial" to allow Lyon to claim depreciation and interest deductions.

STATUTE INVOLVED

Section 163(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 167(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

STATEMENT

This case arises out of the sale and leaseback of a bank building between Frank Lyon Company ("Lyon") and Worthen Bank & Trust Company ("Worthen"), a bank located in Little Rock, Arkansas. The terms of that agreement were the result of arms-length bargaining between the parties and the overall structure of the arrangement was dictated by Federal and state banking regulations with which Worthen was bound to comply.

Worthen began to plan construction of a new multi-story bank and office building in 1965. (Finding 1, Pet. App. 3a; App. 125-126.) Initially Worthen planned to finance, build, and own the project itself at a total cost of $9,000,000 for the site, the building, and an adjoining parking facility. (Finding 2, Pet. App. 4a; App. 131.)

This initial plan was abandoned for two reasons:

(1) Worthen found itself unable to raise the necessary funds because of interest rate limitations imposed by state law; it had planned on a $5 million conventional mortgage and $4 million in debentures, but Arkansas law forbade Worthen (then a state bank) from paying more than six percent on debentures it might issue, and the bonds were not marketable at that rate. (Finding 2, Pet. App. 4a; App. 135.)

(2) Federal Reserve Regulations required Reserve Board approval if the total investment in the bank premises exceeded capital stock; the Reserve System indicated that it would not approve of Worthen owning the $9 million facility, either directly or through a subsidiary, because Worthen's capital stock was only $4 million. (Finding 2, Pet. App. 4a; App. 133-34; P.Ex. 317 at App. 597.)

Worthen then sought to develop a method which would provide Worthen with the use of the building, satisfy the requirements of Federal and state regulators, and attract the necessary capital. It was concluded that this could be accomplished by a sale of the building to an independent outside investor which would not be subject to either of the regulatory restrictions. The outside investor would then lease the building to Worthen for its occupancy and use. (Finding 3, Pet. App. 4a-5a; P.Ex. 5 at App. 328.)

The State Bank Department and the Federal Reserve System approved a proposal for the sale of the projected building and its leaseback to Worthen. Under the arrangement, Worthen would retain control of the adjacent parking facility, but it would sell the bank building and land for $7,000,000 and lease it back from the buyer. (Finding 3, Pet. App. 3a; P.Exs. 2 and 5, App. 322, 328.) The State Bank Department required that Worthen have an option to purchase the leased property at the end of the fifteenth year of the lease at a price set in the agreement (Finding 3, Pet. App. 3a; P.Ex. 6 at App. 366; App. 136, 138-39), and the Federal Reserve System required that the bank building be owned by an independent third party. (P.Exs. 4 and 38, at App. 326, 599; App. 133-34, 139.)

A number of investors were interested in owning the building on this general basis and submitted proposals to Worthen. Lyon heard of the arrangement at this time and submitted its first proposal on October 30, 1967.[1]

Taking the most favorable elements of various bidders' proposals (including a suggestion by Eastman Dillon-Union Securities Co. that sale of the land under the bank be eliminated from the sale to simplify establishment of equitable option prices; P.Ex. 39, at App. 601), Worthen prepared and submitted to the bidders a "Specification for Sale-Leaseback of Worthen Bank and Office Building." (App. 142-144; P.Exs. 12 and 13 at App. 348, 349). Anxious to acquire the building, Lyon proposed a reduction of rent of $21,000 a year for the first five years.[2] Lyon's proposal was accepted by Worthen, and Lyon was approved as an acceptable borrower by First National City Bank (FNCB) for interim financing, and New York Life Insurance Company as a permanent lender. Lyon in fact borrowed the money on these loans.

---

[1] For competitive reasons, Worthen desired to get the building in operation as soon as possible and it had begun construction on a cost-plus basis on September 15, 1967, before the buyer was chosen. (App. 128-30).

[2] Finding 3, Pet. App. 5a; P.Ex. 14 at App. 352; App. 27-28. When New York Life refused to approve the reduction in rent, Frank Lyon and Worthen agreed that Lyon should pay higher than normal interest on an unrelated loan to pay off the acknowledged obligation of $105,000. App. 109-110, 146-147.

Final negotiations on terms began in December 1967 and were not completed until May 1968 (App. 29-30, 36-38, 85-86, 150, 215-216). Intensive discussions about all terms of the arrangement were carried on between Lyon and Worthen (App. 37-38, 121-22), with FNCB and New York Life participating on the financing issues. When the negotiations concluded, FNCB and New York Life required that the final terms be submitted to state and Federal bank regulators for final approval. The regulators approved the terms (P.Exs. 40, 41, 42, 43 and 44 at App. 609, 613, 618, 620, 622).

The result of the complex multi-party negotiations was embodied in a number of interlocking agreements. Worthen and Lyon executed: a ground lease under which Worthen leased the bank site to Lyon (P.Ex. 18 at App. 366); a sales agreement conveying the building to Lyon by general warranty deed (P.Ex. 25 at App. 508); and a building lease under which Lyon leased the bank building to Worthen (P.Ex. 19 at App. 376). Lyon also executed four agreements with New York Life to effect permanent financing of the building (P.Exs. 20, 26, 27, and 28 at App. 443, 523, 527, 571) (Worthen was a party to the first deed of trust, but not to Lyon's note or other agreements with New York Life). In addition, there were numerous agreements relating to interim financing among Lyon, Worthen, and FNCB (P.Exs. 21, 22, 23 and 24, at App. 462, 488, 490, 503) and a consent agreement between Worthen and New York Life which was designed to provide additional assurances to New York Life (P.Ex. 29 at App. 575).

Under the agreements, Worthen gave Lyon a ground lease for 76 years and 7 months on the site of the

bank building and sold the building to Lyon piece by piece, as it was completed,[3] for a total price of $7,640,000. Lyon then leased the building back to Worthen for a primary term of twenty-five years with options to extend the lease for eight additional five-year terms or a total of 65 years (P.Ex. 19 at App. 378). During the period between the end of the building lease and the end of the ground lease, total ownership, use, and control of the building and all improvements thereto were retained by Lyon (P.Ex. 19, Sec. 8.1 at App. 382-83).[4]

---

[3] This arrangement was made because purchase of materials by the bank (by then a national bank) was not subject to Arkansas sales tax, pursuant to this Court's decision in First Agricultural National Bank v. State Tax Commission, 392 U.S. 339 (1968); and sale of the building elements to Lyon was not subject to sales tax, since it was a sale of real estate. (App. 32, 148). The Federal Reserve System would not permit Worthen to complete the building and then sell it to Lyon because Worthen's investment in bank premises could at no time, however short, exceed its capital stock. (App. 152-53).

[4] The rent schedule for the building was as follows (P.Ex. 19, Sec. 3.1 at App. 378-79):

First 11 years of the lease	$ 582,324
Years 12-25	613,157
Option Periods (Years 26-65)	300,000

Total building rent over the initial 25 year lease term equalled $14,988,648.

The ground rents to be paid to Worthen by Lyon were $50 per year for the first 26 years, 7 months, and thereafter (P.Ex. 18 at 367-68):

12/1/94 thru 11/30/99 (5 years)	$ 100,000
12/1/99 thru 11/30/04 (5 years)	150,000
12/1/04 thru 11/30/09 (5 years)	200,000
12/1/09 thru 11/30/34 (25 years)	250,000
12/1/34 thru 11/30/44 (10 years)	10,000

At the end of the 11th, 15th, 20th and 25th years of the lease, Worthen had the option to purchase the building at prices agreed on in the lease.[5]

The lease was a "net lease," under which Worthen was charged with the responsibility for operating the building, for insurance and repairs, and to keep the premises "in good order and condition: except for reasonable wear and tear." (P.Ex. 19, Sec. 7.1 at App. 382.)

To cover the purchase price, Lyon invested $500,000 out of its own working capital and $7,140,000 which it borrowed from New York Life on the permanent loan.

During 1968 and 1969, Lyon paid $453,483.81 interest to First National City Bank on the interim financing. In addition, it paid an aggregate of $58,952.00 for legal expenses, title insurance, audit expenses, and telephone and travel, in connection with the transaction.[6] It deducted $451,666.75 of these expenses on its tax return for 1969.

In December 1969, Worthen took possession. At that time, Lyon received the proceeds of the permanent

[5] The option schedule was as follows (P.Ex. 19, Sec. 20.1, at App. 419-420):

11/30/80 (after 11 years)	$ 6,325,169.85
11/30/84 (after 15 years)	5,432,607.32
11/30/89 (after 20 years)	4,187,328.04
11/30/94 (after 25 years)	2,145,935.00

[6] In the event that Lyon prevails in this case, it agrees that $32,996.19 of these expenses must be capitalized, and amortized over the period of the New York Life Insurance loan and building lease. The parties have stipulated the proper allocation of these expenses, and they are not in dispute. See Supplemental Stipulation, App. 7; Finding 4 of the district court, Pet. App. 10a.

loan on the building from New York Life, and it discharged the interim loan which had been made by FNCB. On its tax return for 1969, Lyon accrued $48,527.01 as rental income from Worthen for the month of December 1969. It also accrued a deduction for interest for one month, owed to New York Life, in the amount of $40,162.50; and it accrued depreciation on the Worthen building for one month in the amount of $51,618.79.

In auditing Lyon's return for 1969, the Commissioner determined without further explanation that Lyon "is not the owner for tax purposes of any part of the Worthen building." On this basis, he made three adjustments in Lyon's return, as follows (Finding 10, Pet. App. 7a-8a; P.Ex. 52 at App. 689):

1. The Commissioner disallowed all of the interest and expenses paid during the period of construction, in the aggregate amount of $451,666.75.

2. The Commissioner reversed the items for rent, and for interest and depreciation on the completed building during the month of December 1969. Specifically, he removed the accrued rental for one month from Lyon's income in the amount of $48,527.01. He disallowed the deduction for interest payable to New York Life for one month in the amount of $40,162.50; and he disallowed the deduction for depreciation on the Worthen building for one month in the amount of $51,618.79.

3. Finally, the Commissioner added an item of $2,298.15 to Lyon's income for 1969, as "accrued interest income."[7]

[7] These adjustments may be summarily stated as follows (Find-

The final item added to Lyon's income was based on the assumption that Worthen would exercise its option to buy the building after eleven years, on November 30, 1980, at the option price stated in the lease, which was $6,325,169.85. App. 288. In addition, the Commissioner determined that Lyon loaned $500,000 to Worthen, although Worthen gave no note, and did not otherwise obligate itself to pay $500,000 to Lyon on account of a "loan." On the basis of his determination that there was a "loan," the Commissioner then computed, or imputed, interest on this loan, as follows (P.Ex. 52 at App. 689):

"Option price of Worthen Building, 11/30/80	$6,325,169.85
Loan Balance to New York Life Ins., 11/30/80	5,521,813.36
Balance	$ 803,356.49
Cost	500,000.00
Gain	$ 303,356.49

ing 10, Pet. App. 7a-8a; P.Ex. 52 at App. 689):

1. Accrued rental income for 1 month from Worthen		$(48,527.01)
2. Accrued interest for 1 month owed to New York Life		40,162.50
3. Depreciation for 1 month on Worthen building		51,618.79
4. Expenses paid during construction:		
(a) Interest paid to FNCB	$403,899.54	
(b) Legal expense	33,351.05	
(c) Title insurance	10,140.00	
(d) Audit expense	3,475.00	
(e) Telephone and travel	801.16	451,666.75
5. Accrued interest income		2,298.15
Total increase in reported income		$497,219.18

"This gain of $303,356.49 is considered the equivalent of interest income to be accrued over the (11) eleven-year period of the lease to the option date 11/30/80.

1969 Interest—$303,356.49 ÷ 11 ÷ 1/12 = $ 2,298.15

1970 Interest—$303,356.49 ÷ 11 = 27,577.86"

Lyon paid the resulting deficiency. After a refund claim was disallowed, Lyon brought this suit in the United States District Court for the Eastern District of Arkansas, to recover the deficiency paid for the year 1969. The taxes paid or due for 1968 and for 1970 and subsequent years are in abeyance pending the decision of this Court.

The district court held that the petitioner's depreciation and interest deductions were allowable. The court concluded that the legal intent of the parties had been to create a bona fide sale and leaseback, and that the arrangement substantively achieved this goal. The court rejected the notion that Worthen was acquiring an equity in the building through its rental payments, finding that the rents were reasonable throughout the period of the lease, and that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates (Pet. App. 2a, 6a).

In light of the bid competition for ownership, the district court rejected any negative inference to be drawn from the fact that the rentals combined with options were enough to amortize the New York Life loan and to pay Lyon a six percent return on its equity investment (Pet. App. 13a; 10a). The court concluded that it was highly unlikely as a practical mat-

ter that any purchase option would ever be exercised (Pet. App. 2a; 6a). Likewise the court rejected any inference built on the fact that it was a "net" lease which, the court noted, is a common form of long-term real estate lease (Pet. App. 12a).

Despite these clear findings, the court below reversed the decision of the district court. In its analysis, the court of appeals likened ownership for tax purposes to a "bundle of sticks" which represent the various benefits and burdens associated with ownership. The court undertook its own evaluation of the facts, and adopted the conclusion that "the taxpayer [Lyon] totes an empty bundle" of ownership sticks (Pet. App. 25a), i.e., that Lyon's ownership interest was too insubstantial to support the claimed depreciation despite the fact that Lyon retained all the risks and benefits if the options were not exercised, or if Worthen should become insolvent. Without much consideration, the court also disallowed the interest deduction on the same general basis.

SUMMARY OF ARGUMENT

The approach adopted by the court below in denying Lyon depreciation and interest deduction is inconsistent with sound tax policy.

Lyon and Worthen arrived at the sale-leaseback reflected here as a result of hard arms-length bargaining; the framework for their efforts was provided by banking regulations which precluded Worthen from owning the building. The particulars of the transaction arose out of competition between potential investors. Lyon was fully and solely liable as a matter of law on the loans, on which it paid and deducted in-

terest, and Lyon did in fact incur and pay the interim construction expenses which it deducted.

The arrangement is clearly not a sham. The District Court affirmatively found the option prices and rentals to be reasonable. In these circumstances, tax consequences should follow the parties' structuring of the transaction because there is no real reason to tax it otherwise. Moreover, there are numerous reasons *not* to restructure the transaction—including predictability and fairness to taxpayers involved in bona fide transactions, and efficiency in the administration of the tax laws. Although a recognition of these considerations can be discerned in prior case law dealing with sale-leaseback, in other "debt" characterization cases, and in analogous areas of tax law, there is none whatsoever in the reasoning or approach of the court of appeals. Compare *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974); see also *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939).

Consideration of some of the main features of the transaction supports this conclusion as well. Lyon will sustain depreciation through decreasing option prices and decreasing rentals. Lyon is and will remain solely liable on the New York Life loan; the Government has ignored this obligation entirely because, in its analysis, the rent "flows through" Lyon to cover the obligation. But this analysis neglects the concrete importance of having such an obligation, and ignores this Court's ruling in *Commissioner* v. *Brown*, 380 U.S. 563 (1965). Similarly, the court failed to give any tax substance to obligatory banking regulations by holding in effect, that Worthen was the owner for tax purposes of a building Worthen could not legally own.

This approach was rejected by this Court in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972).

The overall unreality of the Government's approach is manifest in its denial of deductions for interest. It does not dispute the fact that Lyon was solely liable to pay loan interest nor that it had done so. The Government nonetheless denied interest deductions and taxed Lyon for accrued "interest income" assuming, in the absence of any factual support or legal obligation, that Lyon had made a "loan" to Worthen which would mature and be retired by exercise of Worthen's option at the end of the eleventh year of the lease.

The court below should not have presumed to determine tax substance as a pure matter of law and disregard the clear and specific findings of the district court. This approach is at odds with proper appellate procedure, as well as other decisions (*see, e.g., American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974)), and it leads to such anomalous results as taxing Lyon for "phantom income" on a nonexistent 11 year loan. The district court's findings upheld the taxpayer on every point and should be upheld here.

The decision below, if allowed to stand, frustrates the bargained intention of the parties here and unsettles negotiations and planning by future taxpayers. Fairness, tax policy, and proper procedure all point toward reversal.

ARGUMENT

I. THE TRANSACTION SHOULD BE TAXED AS IT WAS STRUCTURED BY THE PARTIES – AS A BONA FIDE SALE AND LEASEBACK

Sale and leaseback arrangements are widely used as a flexible means of developing and controlling business property and dividing ownership interests in it. Typically, the sums involved are substantial, and the legal arrangements necessary to meet the particular situation are complex. Flexibility of form is an important part of the utility of the device. This flexibility is hampered to the extent tax consequences depend, as in the reasoning of the court below, on an after the event decision of a court, which is contrary to the intent of the parties as expressed in their bargain, and based on a rigid conception of what a "bona-fide" sale is, or an attempt to pull apart the elements of the transaction and assess them against an artificial standard of full ownership.

The bargain achieved by the parties here, with its balance of bartered benefits and responsibilities, and the good faith tax planning which inevitably affected the parties' estimation of these benefits, should not be frustrated unless there is some substantial reason based in tax policy to do so. The court of appeals recognized this principle explicitly, when it said (Pet. App. 23a):

> Since parties are generally free to dispose of property interests as they wish, the substance of a transaction usually derives from the parties' intent. Subject to certain policy considerations, the courts will respect the actual allocation of interests made by the parties even though it reduces or eliminates the tax liability. Helvering v. F. & R. Lazarus & Co., [308 U.S. 252]; Gregory v. Helvering, 293 U.S. 465 (1935).

But in attempting to apply the stated principle to the present case, the court below failed to relate its approach to any conception of tax policy, resting its result on an unstructured assessment of "burden and benefits" of ownership held by Lyon and Worthen.

In this case, there is no reason not to treat the sale and leaseback as bona fide. Hard bargaining at arms length has resulted in a complex distribution of the perquisites of ownership and use. The parties have not tried to "fool" the tax laws, nor is Lyon insulated from the wasting of capital, for which the depreciation deduction compensates, by any assurance, either legal or practical, that the options will be exercised or its investment otherwise returned in full. See Pet. App. 11a, and footnotes 12 and 28 *infra,* pp. 20-21, 48.

The specific issue here is Lyon's right to take depreciation and interest deductions. The court of appeals felt that this turned on whether the substance of the sale-leaseback was consonant with its form. "Substance over form" has two fairly clear functions in tax law. First, a party should not be allowed to use purely formal labels or maneuvers to frustrate the intent of tax provisions. *Cf. Gregory* v. *Helvering,* 293 U.S. 465 (1935). Second, economic decisions should not be distorted by attempts to achieve tax benefits which present no economic benefit. *Cf. Knetsch* v. *United States,* 364 U.S. 361 (1960). The negative side of the use of the doctrine is that upsetting the bargained intention of the parties will always involve costs. There is additional administrative effort for the Government in discerning and contesting lack of "substance." Taxpayers bear the burdens of uncertainty and unfairness in their efforts to plan, as well as in

frustrated plans and scrambled bargains; too extensive or uncritical a use of "substance over form" can be counterproductive, distorting economic decision-making rather than avoiding distortion.

If, as here, the parties have substantial non-tax motives for the transaction, and bargain in good-faith over details and consideration, the transaction is not a mere rearrangement of labels for tax purposes. If, as here, there is no differential in tax rate, or any special tax circumstance affecting one of the parties, then it is clear the transaction is not a sale of tax benefits, and it is unlikely that tax considerations disproportionately influenced the nature of the transaction or its terms. Finally, since the trier of fact determined the rents and option prices to be reasonable, there is no factual basis to infer that rent is building up equity, or that the lessee will inevitably exercise its options and become the owner of the building. Under these circumstances, there is no justification for scrambling the bargain between Lyon and Worthen, and injecting unnecessary uncertainty into the future planning of bona fide sale-leaseback transactions.[8]

Although the court of appeals denied that its opinion condemns sale and leaseback arrangements (which it characterized as useful and proper business devices), the court recognized that the features of which it saw as fatal in the Lyon arrangement are ordinary ele-

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[8] Cases involving gift leasebacks, often in intra-family situations, present a much greater danger of tax avoidance and wholly different policy considerations. Cf. Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965). Here the transaction is a commercial one bargained out at arms length, and the parties are subject to identical tax rates, so there is no effort to take advantage of a tax differential.

ments of valid sale and leaseback arrangements. The court also agreed that the same features are found in many cases in which sale and leaseback arrangements have been upheld. In effect, the court of appeals denied Lyon's entitlement to depreciation deductions on the basis of an unfocused overall comparison between sale-leasebacks and less sophisticated ways of holding property. By relying on the "cumulative effect" of various features which would otherwise be unobjectionable in a sale and leaseback transaction, the court made it impossible for a future tax planner to structure such an arrangement with any confidence or security, thus unsettling both the administration of the tax laws and the good faith efforts of taxpayers to comply with those laws.

Prior case law concerning sale and leasebacks, support Lyon's entitlement to depreciation and interest deductions. In other cases, the courts have put substantial emphasis on the intent of the parties in determining the practical effect of the parties' allocation of interests and the tax treatment of sale-leaseback transactions. Intent moreover is to be derived in light of the factual circumstances existing at the time the contract was made.

The principles are well expressed in *Benton* v. *Commissioner,* 197 F.2d 745, 752 (5th Cir. 1952):

> "There being here involved no restraint by law or public policy, the parties had full liberty to contract as they pleased. Whether what is in form a lease is in effect a conditional sale contract depends on the intention of the parties. The economic relation of the value of the property to the option price was only one factor to be considered in determining intent. Further that factor must

> be considered not as of the time for the exercise of the option, but rather in the light of the facts and circumstances as they existed at the time the parties entered into the contract. . . Within the limits of reason, the parties had a right to exercise their own judgment, and that of the Commissioner or of the Tax Court cannot be substituted therefor.
>
> If the parties in good faith actually intended to enter into a lease contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property."

These principles have long been solidly established in the case law [9] and they have recently been reaffirmed by the Fourth Circuit in *American Realty Trust* v. *United States,* 498 F.2d 1194 (1974), and by the Ninth Circuit in *Cubic Corporation* v. *United States,* 541 F.2d 829 (1976).

Proof can, of course, be offered to show that the transaction between the parties is not a bona fide sale-leaseback. If the rentals are shown to be unreasonably high, the court may conclude that the parties intended them to be partial payments of a purchase price. The option prices may be so low that it is inevitable that the option will be exercised and obvious that the par-

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[9] *See, e.g.,* Helvering v. Lazarus & Co., 308 U.S. 252 (1939); Meiselman v. Commissioner, 300 F.2d 666 (4th Cir. 1962); Western Contracting Corp. v. Commissioner, 271 F.2d 694 (8th Cir. 1959); Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955); Arkansas Bank & Trust Co. v. United States, 224 F. Supp. 171 (W.D. Ark. 1963); Kearney & Trecker Corp. v. United States, 195 F. Supp. 158 (E.D. Wis. 1961); and Reade Manufacturing Co., 32 T.C.M. 1225 (1973).

ties intended that it would be; the lessee may be "economically compelled" to exercise an option.[10] The legal "owner" may be a mere straw man rather than a wholly separate business entity with distinct goals and interests in entering the transaction.[11] If such proof is shown, there is some basis for a determination that a "sale" is a loan, or a "lease" a sale.

There was no proof here to contradict the district court's conclusions that the option prices were reasonable and that Worthen was unlikely to exercise its options at any time; nor did the Government ever offer any indication that Lyon's desire to diversify with a solid real estate investment,[12] or Worthen's

[10] *See* Lefevre, "The Tax Law of Lease Transactions Revisited," 53 *Taxes* 764 (1975), suggesting that this is the general rule, and cases cited therein.

[11] The Federal Reserve System required that the owner of Worthen bank be an independent outside investor, and rejected a plan for a wholly-owned subsidiary to own the building. P.Exs. 4 and 38 at App. 326, 599; App. 133-34. Frank Lyon Co. was (and is) in fact a substantial independent operation with assets of $12,225,612 and a net worth $3,818,671 at the end of 1968 (before including the bank building in its assets). P.Ex. 33 at App. 587.

[12] The principal motivating factor for Lyon was diversification, App. 48, 371. By far the major part of Lyon's business was distribution of home appliances, principally from RCA and Whirlpool. App. 19-20. Lyon considered it wise to diversify because they had saturated their primary market areas under their contracts with the manufacturers, App. 20; moreover, their contracts with their two major suppliers could be cancelled on thirty days notice. App. 48-49.

The Worthen investment appealed to Frank Lyon because a number of the directors were familiar with real estate investments; anticipated solidity of the investment and good cash flow, after tax in the early years, and before tax later; 2.9 million dollars anticipated income in the ten year period between the end of the building lease and the end of the lease in the underlying fee; disposal

need to stay within federal guidelines and preserve its capital position, were not the substantial motivating factors the district court found them to be in assessing the transactions.[13]

The tax law should not, in other words, hamper or distort the good faith planning of a bona fide transaction. The tax laws should, rather, take the transaction between the parties as it finds it, instead of restructuring it to suit a conception of the transaction which is at odds with the parties' practical understanding of the value and nature of the interests involved.

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of, or reimbursement for, the building at the end of the 75 year ground lease. App. 48-54; see also App. 260 (indicating that Lyon assumed that Worthen would not be able to exercise any of the options).

[13] The record shows that Worthen had at the time of the transaction and continues to have problems in keeping its capital up to that required by its growing deposits. App. 133-39; P. Ex. 4 and 38. "As rapidly as they are growing under the leadership they have I don't think that's going to stop any time in the foreseeable future. Like most aggressive banks, they are going to be in a capital bind." App. 260. In passing on the transaction involved here, Mr. Wyrick of the Federal Reserve System noted that Worthen's capital position had been a cause of concern in the past and urged the directors of the bank to review it frequently. P. Exs. 4 and 38 at App. 326, 599. In discussing the sale-leaseback, Worthen focused specifically on the capital advantages of the sale-leaseback in submitting the plan to the State Bank Commisioner. P. Ex. 5 at App. 329:

> "We realize that the sale and leaseback might be slightly more expensive in the long run. However, we are of the opinion that the advantages it offers us by not tying down our capital in land and building leaves us more leeway in the management of our bank and keeping our funds more profitably employed."

The capital problem has continued (as Frank Lyon expected that it would, App. 260) and makes it highly unlikely that any option will be exercised. App. 166-172. See also pages 30-34, below.

In an arms-length sale of a business, the parties' allocation of the purchase price among the tangible assets of the business and a covenant not to compete and goodwill will be followed by tax consequences. See *Commissioner* v. *Danielson*, 378 F.2d 771 (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967). In the *Danielson* case on remand the Tax Court held that the contractual allocation of the parties was binding in the absence of fraud, duress, or undue influence. *Carl L. Danielson*, 50 T.C. 782 (1968). In *Benjamin Levinson*, 45 T.C. 380 (1966), the allocation in the sales contract was upheld although $142,000 of the total $147,000 price was allocated to the covenant not to compete. The Commissioner has formally acquiesced in this decision. 1966-2 Cum. Bull. 5. The divergent interests and non-tax motivations of the parties provide a protection against sham that is more effective and sensible than a microscopic examination of the equivalents exchanged. Both parties here are inextricably bound up in the ownership of the property, and it is more useful and sensible to recognize this fact than to attempt to tote up the elements of ownership each has.[14]

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[14] In *World Publishing Co.* v. *Commissioner*, 299 F.2d 614 (8th Cir. 1962), the court adopted a more realistic approach to the tax consequences of divided interests in property. There the taxpayer purchased from the original lessor property on which the lessee had built a building. The original lessor had made no capital investment in the improvements and was clearly not entitled to depreciation deductions. It was conceded that the lessee could depreciate the building as an improvement it had made to its long-term lease-hold. The issue was whether the taxpayer purchaser was entitled to a depreciation deduction on the basis of its investment in the property as a whole. Declining the Government's invitation to find a barrier in an asserted theoretical "anomaly" in two parties claiming depreciation, the court (per Blackmun, J.) looked to the purpose of the depreciation deduction—to reflect the wasting of capital investment—and concluded that the taxpayer as well as the lessee had a depreciable capital interest.

> "What is significant is that each taxpayer has a separate wasting investment which meets the statutory requirements for depreciation. To allow each to recover his own, and separate, investment is not, as is suggested, to permit duplication at the expense of the revenues and is not to permit one taxpayer to depreciate another's investment. That each is concerned with the same building is of no relevance. Farnam has its lessee's cost of the structure and the present taxpayer has the portion of its purchase price attributable to the building. If two taxpayers own undivided interests in improved real estate, each may be entitled to depreciation. The situation here is not dissimilar." 299 F.2d at 622-23.

It is, in short, more important to recognize that Lyon has a real interest in the building than to parse out that interest in order to compare it either to Worthen's interest or to some artificial standard of full ownership.

In terms of the doctrine of substance over form, it is clear that the parties are not in any way attempting to take advantage of the tax laws, if, as the district court found, the rental rate and the option prices are reasonable. The Government here undertakes the burdensome and artificial exercise of weighing the exchange of equivalents in an arms length transaction to determine "true ownership", without any indication that the policy of the tax laws in general or of the depreciation deduction in particular is furthered. It is clear that this impractical and unrealistic method of determining tax consequences will encourage litigation and often distort good faith economic planning.

II. THERE IS NO BASIS FOR DISALLOWING THE DEDUCTION OF INTEREST WHICH LYON PAID ON MONEY IT BORROWED.

Section 163(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

The record clearly establishes that Lyon borrowed money from FNCB on the interim loan, and from the New York Life Insurance Company on the permanent loan, and that it was liable for interest on these loans. FNCB's commitment letter stated the explicit understanding that "an acceptable real estate company [Lyon] would be the actual borrower" and that Worthen Bank "will not actually be guaranteeing our loan." (P.Ex. 16 at App. 356-57). Lyon, and Lyon alone, signed the note to FNCB. (P.Ex. 22 at App. 488-89).

Similarly the commitment letter of New York Life Insurance Company was addressed to Lyon (P.Ex. 17 at App. 358; App. 28-29). Lyon, and Lyon alone, signed a note evidencing its obligation (P.Ex. 26 at App. 523). Lyon gave a deed of trust on the building and on its lease as security for its obligation; Worthen joined in this deed of trust since it owned the fee of the land. (P.Ex. 27 at App. 527).

Thus, the record establishes clearly that Worthen did not owe money to FNCB or to New York Life, and that Lyon did. It was Lyon, and Lyon alone, which was liable to these lenders for interest on the debt, and eventually for principal payments. Lyon

is not only liable for the payment of the New York Life loan whether or not Worthen pays its rent, but also will remain liable on the loan in the event Worthen exercises one of its options to purchase the building and subsequently defaults in payment of the note. (App. 687-88, 207).

Lyon was in no sense an agent for Worthen. It was not subject to Worthen's domination or control. Indeed, the banking authorities had required that the owner of the building should be an independent entity, and had refused to approve an arrangement under which the building would be owned by a subsidiary of Worthen. (P.Ex. 4 at App. 326.)

In this situation, section 163(a) of the Code is clearly applicable. There was indebtedness, on which Lyon was solely liable on full recourse loans. Interest accrued on that indebtedness. Congress has specifically provided that "interest paid or accrued within the taxable year on indebtedness" is deductible. No justification is perceived for the action of the court below in denying the deduction for interest on either the interim loan with FNCB or on the permanent loan from New York Life.

Even if Lyon had been a wholly owned subsidiary of Worthen—which it was not—Lyon would have been entitled to the deduction for interest on *its* indebtedness. *Cf. National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949). There is no dispute that Lyon borrowed money from FNCB and from New York Life, and paid interest on both loans. Lyon was the only borrower. Worthen was not liable on the loan; it could not legally undertake the loans. Worthen did not pay any interest. It was under no obligation either to pay interest or to reimburse Lyon. The de-

cision below denying a deduction for interest which Lyon owed, and properly accrued, and for which Worthen was not liable, and could not legally be liable, cannot be supported.

III. CONSIDERATIONS OF TAX "SUBSTANCE" SUPPORT LYON'S CLAIM TO THE DEDUCTION OF DEPRECIATION, INTEREST, AND EXPENSES.

The economic reality of the Lyon-Worthen sale-leaseback is in sharp contrast with the characterizations presented by the Government and accepted by the court of appeals below.

The Government's picture of the transaction is basically a caricature, oversimplified to the point of unrecognizability. In the Government's view, Lyon has "loaned" Worthen the $500,000 equity cash which Lyon invested in the project, since, it is said, Lyon will receive this back at six percent interest when Worthen exercises one of its options. The Government argues that Lyon's liability to New York Life should be disregarded entirely; since rent from Worthen is equal to Lyon's liability to New York Life, the Government says that Lyon was acting merely as a "conduit" for payments between Worthen and New York Life. What this picture omits is any appreciation of the real and practical situation which faced the parties at the time they entered into this transaction, and of how the problems and uncertainties of that factual situation illuminate the terms of the transaction.

A. Under The Agreement, Lyon Is The Party Most Likely To Sustain The Burden Of Depreciation In The Value Of The Building Through "Wear And Tear" Or "Obsolesence."

The depreciation deduction is designed to reflect the economic loss suffered through exhaustion of a capital

asset, because of "wear and tear" or "obsolescence." I.R.C. § 167(a). See *e.g.*, *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939). In applying its "bundle of sticks" test, the court of appeals below looked to the operating rights and responsibilities which Worthen had been able to obtain in negotiations of the terms, and ignored the burden of wear and tear and obsolescence actually borne by Lyon.

The court emphasized that it was a net lease; that the investment credit was passed to Worthen;[15] that the level of lease payments and purchase option prices were designed to cover the loan obligation and provide a six percent return on Lyon's initial equity if the options were exercised; that there was no before-tax cash flow in the early years; and that Worthen shared significantly in division of condemnation awards. The court concluded: "The contract provides for no return to Lyon related to ownership risk." (Pet. App. 28a). It is, of course, the risk of wear and tear and obsolescence that is significant in terms of the depreciation deduction, and not operating risks which Worthen assumed or the limits which Worthen has been able to place on returns for Lyon's risks. Worthen's obligation to repair, maintain, and insure the building, explicitly excludes "reasonable wear and tear," the statutory definition of depreciation. I.R.C. § 167(a); P.Ex. 19, Sec. 7.1 at App. 382.[16] Full appre-

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[15] Since, I.R.C. § 48(d) permits a lessor to pass on the investment credit to a lessee at will, this factor should not, of course, have had any impact on the court's analysis.

[16] Worthen's responsibilities under the lease are distinct from Lyon's burden of depreciation in tax law as well as in fact. This is demonstrated by consideration of the tax consequences of any repairs, replacements, or maintenance expenses incurred by Wor-

ciation of the factual setting and prospects of the sale-lease transaction makes it clear that Lyon continues to bear this burden.

1. *Option Prices and Rentals.* The option prices and rentals through the 25-year period of the initial lease term are geared to the totals necessary to provide Lyon with current funds to repay the New York Life loan and, *if one of the options is exercised*, achieve a six percent compounded return on its initial equity investment. This does not mean, of course, that the option prices and the rentals were not fair and reasonable as the district court found them to be. C. V. Barnes, an independent realty expert, testified that the option prices and rentals were reasonable estimates of market values (App. 236-237, 240-242),[17] and the district court found that they were the reasonable estimates of market price arrived at as a result of hard, arms-length negotiations.

The Government offered no evidence to the contrary. Its position amounts to a declaration that rents and options geared to six percent return on initial equity

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then. Some of these expenditures could be for improvements, and could be capitalized and depreciated by Worthen, I.R.C. § 178, Reg. § 1.167(a)-4; others could be deducted as ordinary and necessary business expenses in the year of expenditure. See generally Journal-Tribune Publishing Co. v. Commissioner, 348 F.2d 266 (8th Cir. 1965). The expenditures would, in any case, whether incurred by Lyon or Worthen, be distinct from the underlying capital interest in the building which would continue to be depreciated no matter who incurred the additional expenses or capital investments. See also note 14, supra, pp. 22-23.

[17] "[T]he square foot rental rates related favorably to the rental rates being charged in other comparable office buildings." App. 236.

cannot, as a matter of law, be a valid estimate of fair and reasonable values. This position ignores the reality of the bargaining process. In attempting to estimate fair option prices and rentals at times far in the future, and to give the security to the lenders and the assurances to the banking authorities which each required, it is natural that bargaining would take place around the area of the amount necessary to retire the New York Life loan.[18] The variable factor in the negotiations was the amount of return to Lyon above the amount to retire the loan. The district court reasonably found that the resulting return, arrived at through arms-length negotiations, was a good faith effort, and a fair success, as an estimate of market values at the times in the future. (Findings 6 & 7, Pet. App. 5a, 6a). Presumably if the parties' estimate of future values had been different, the six percent "interest" figure, on which the Government relies so heavily, could have been either greater or lesser.

The option prices and rentals that were arrived at not only represent reasonable estimates of values, they show a downward trend which is, according to the independent realty expert who testified at the trial, quite compatible with the lessening value of an aging building. (App. 240-241). It is the Lyon Company which sustains the economic loss associated with the age of the building in collecting the decreased ren-

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[18] As Mr. Barnes testified, App. 239:

> "Again, this is a general practice in the industry. When you make a lease or sale leaseback you have to have some number upon which the negotiations take place over. It's very common in build-to-suit property for the parties to agree on a dollar figure and then for the lessee to pick up any additional expense in the form of leasehold improvements."

tals or—if the options are exercised—the decreasing option prices paid for it.

In *Northwest Acceptance Corp.*, 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974), the Tax Court upheld the owner-lessor's claim for a depreciation deduction against a Government contention that the taxpayer did not have a substantial enough economic interest in the leased property to support the claim. The court distinguished cases in which the taxpayer's interest had been found to be too insubstantial to justify depreciation in the following terms:

> Both cases, however, are clearly distinguishable for the taxpayer in each stood no risk of investment loss for the years in which the depreciation deductions were claimed. In both instances the *taxpayer was guaranteed a sale of the rented property at the end of the rental term at a price equal to the fair market value of the property or the taxpayer's investment at the beginning of the rental term.* On the other hand, in the instant case the sales prices under the dealer repurchase agreements and the purchase options are considerably lower than the value of the equipment at the consummation of the leases. *The depreciation of the rented property during the lease term, as reflected in the lower option prices, is certainly deductible by someone, and since we have determined petitioner to be a bona fide lessor, it is entitled to the deductions.* 58 T.C. at 849-50 (emphasis added).

Lyon has no assurance, or even a practical expectation, that the options will be exercised, though it is certain the option prices and rentals decrease over time.

2. *The 25-Year Breakpoint.* Both the independent realty expert and the president of Worthen Bank testified that functional obsolescence or other factors would make it likely that Worthen Bank would need another new building by the end of the 25-year period. Mr. Penick, president of Worthen Bank, testified that: "25 years is about the maximum it [a bank] can stay in any one place in a functional building." (App. 171.)

> Q. "Do you think Worthen Bank at the end of 65 years would still be in that building?"
>
> A. "Not if history repeats itself. I think we probably would have gone through another building besides this one by that time." (App. 172.)

Mr. Barnes, the independent realty expert, indicated that the principal thing in determining value of a building in the far future is "functional obsolescence, not its physical situation."

> "[A]fter they [other buildings in Little Rock with which he was familiar] were some 25 or 30 years old they had to have some extensive money spent on them to cure a problem, and certain functional problems you couldn't cure. So the result is that that type of age building rents for less money which results in the value being less than it would if you could rent it for what a class A building would rent for." (App. 241.)

It is at this point in the life of the building, in 1994 25 years down the road, that Worthen Bank becomes free of its absolute lease obligation. Succeeding renewals of the lease up to the end of the total option periods (65 years in the aggregate), come at 5 year intervals, indicating the increased uncertainty of the parties that the building will continue to meet Worthen's needs. In 1994 Worthen can (1) buy the building at a purchase price of 2.1 million dollars, (2) continue to rent the building at reasonable rentals, or (3) it can

seek out new quarters, all at its own choice. The testimony of Worthen and Lyon, as well as that of Mr. Barnes, the independent realty consultant, and the findings of the court, all indicate that exercise of the option at 25 years, or at any other time, is the least likely possibility. (App. 136-138, 164-172, 251, 261.)

Since Worthen is, at the end of the 25-year term of the lease, free of any obligation to rent or buy, it is also free to negotiate a new and lower option price if the value of the building has declined below the figure specified in the contract. In short, the burden of depreciation below that value is all borne by Lyon rather than Worthen. In the option prices and reduced rentals, Frank Lyon will bear the burden of ordinary depreciation of the building in accordance with the parties' estimates of future value. If the depreciation in value is, however, for some reason extraordinary, Frank Lyon must bear that burden as well, by selling at a price less than the option price, by renting at rentals less than the option rental, or by taking possession and control of a building that is much devalued if not functionally obsolescent.

The Government argued below that Worthen would not simply walk away from the "equity" that it has built up on the building at the end of 25 years. This line of argument, of course, begs the question. At the end of the 25-year period, Worthen will act in its own best economic interests. The building may have depreciated in value or usefulness to Worthen to a point below that reflected in the rentals and option price stated in the contract, or Worthen may well, as we have seen, want a new building. If Worthen has paid no premiums in rentals in return for a lower than market option

price (and the testimony and findings below indicate that it did not, App. 236), then Worthen loses nothing by walking away at the end of 25 years, and Mr. Barnes and Mr. Penick both indicated that on the basis of their experience in the field, this was not at all unlikely. App. 171-72, 251-52. In any event it loses nothing by walking away at the end of 25 years, if the agreed upon option price is greater than the building's current worth to Worthen. It will not buy unless the building is then worth more than the option price.

If the building depreciates in value to the level below the option prices it will be Lyon which bears the financial burden of depreciation due to wear and tear, obsolescence, or merely an unfortunate change in the neighborhood. The inescapable conclusion is that Worthen has passed all risks of depreciation to Lyon while retaining for itself operating control, and only such other operating and casualty risks as any long-term lessee might have.

None of these possibilities is offered as a certainty. The range of possibilities, however, and the range of Lyon's consequent exposure to loss through depreciation, should indicate the spuriousness of the Government's certitude about what will happen 11 or 25 years down the road.

When we look to the factual basis of this certainty about real estate in general and the long term real estate market in Little Rock, Arkansas, in particular, we find that it is extremely narrow. The field agent of the IRS who initially determined that Worthen bore nearly all the burdens and benefits of ownership had only slight experience in real estate transactions and next to none in the sale-leaseback area. (App. 274-76.) The

court of appeals in assessing the same burdens and benefits, felt that it could do so on the basis of the documents themselves without any apparent appreciation of the factual probabilities and concerns that animated the parties. See also section IV *infra,* pp. 46-54.

B. The Spurious Nature Of The Commissioner's Action Is Clearly Shown By The Inclusion In Lyon's Income Of Imputed "Interest" From Worthen.

As indicated in the statement above (pp. 9-11), one of the elements in the Commissioner's adjustment of Lyon's taxes for 1969 was the inclusion of "accrued interest income" in the amount of $2,298.15. This figure was arrived at by an involved and highly artificial process. It may fairly be called "phantom income."

In the first place, it was *assumed* that Worthen would exercise its option to buy at the end of eleven years, or on November 30, 1980. The option price on that date is $6,325,169.85. On that date, if everything goes on schedule, the payments due from Lyon to New York Life Insurance Company will be $5,521,813.26. The difference is $803,356.49. Against this figure, the Commissioner allowed $500,000 as the amount of Lyon's "loan" to Worthen. This left a balance of $303,356.49. The Commissioner said that this sum "is considered the equivalent of interest income to be accrued over the (11) eleven-year period of the lease to the option date 11/30/80." Accordingly, the Commissioner divided this figure by eleven (for the years), and then by twelve (to get one month), and obtained $2,298.15, which he determined was "accrued interest income" from Worthen to Lyon for the month of December 1969.

It is hard to think of anything in the tax law more artificial and unreal than this. There was no loan from

Lyon to Worthen. Lyon paid no money to Worthen. Worthen undertook no obligation to exercise the option on November 30, 1980. Yet, the Commissioner says that there is "interest" running from Worthen to Lyon, and that a proportionate amount of this accrued in 1969. To find an accrual where there is no loan, no indebtedness, and complete uncertainty as to future events is surely novel.

It was more than fifty years ago that this Court established the basic rule for accrual in *United States* v. *Anderson,* 269 U.S. 422 (1926). In that case, the Court held that an item (there a tax) accrues when "all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it" 269 U.S. at 441. See also *Spring City Foundry Co.* v. *Commissioner,* 292 U.S. 182, 184-185 (1934), and section 1.446-1(c)(ii) of the Income Tax Regulations, which provides:

> "(ii) *Accrual Method*
>
> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income . . ."

Clearly, the present case does not come within this rule. Quite apart from the fact that there was no debt for money loaned by Lyon to Worthen, and no obligation to pay interest, the receipt by the taxpayer here of the alleged interest income is entirely dependent upon whether an unrelated party will ever exercise any one of several options to purchase property. In this situation, the taxpayer's right to the alleged interest income is surely not "fixed," and is thus not accruable. The district court made explicit findings to this effect

and rejected the attempted accrual, calling the "loan" theory "completely untenable both in fact and in law."[19] (Pet. App. 11a, 13a.) Indeed, it is an illustration of the extent to which artificiality can enter into tax determinations when they depart from the basis of legitimate transactions as the parties have structured them. There should be no such "phantom income" in this very real situation.

The unreal nature of the Government's approach, exemplified in this otherwise small matter of the "accrued interest income," permeates its handling of the whole case. Lyon was in fact an independent operator. It bought property, put in some of its own money and borrowed the rest of the money to pay for the property and rented it to a tenant. The Government's effort to rewrite this transaction in different terms finds no support in the tax laws, and would lead to great uncertainty in tax planning and tax administration, and would

[19] It is illuminating to consider the analytical process that went into the initial determination that the arrangement here was a "loan" which would be paid by exercise of the 11th year option. On cross-examination the I.R.S. representative who initially made this determination testified that he assumed that the option would be exercised at the end of the eleven years because "that was the first option period for it to be exercised." When asked on what basis he had assumed it would be exercised at all, he replied: "On the basis that it was a loan." (App. 288). He had previously stated that his analysis was the result of several factors, no one of which was determinative, but when confronted with the question of the impact on his "loan" theory of proof that Worthen would at no time exercise the option: "You mean if at no time Worthen exercises the option? If Frank Lyon continues to be the owner of the building per se? It wouldn't be right. It wouldn't be valid." (App. 282). He later qualified this statement with regard to the impact on his analysis of the situation as a whole by saying he "would have to study it some more." (App. 285). Compare the text at pp. 48-49, infra, and nn. 28 and 29.

inevitably add to the amount of litigation brought before the courts.

C. The Government's "Conduit" Theory Of The Loan Payments To The New York Life Insurance Company Is Inconsistent With The Legal Obligations Of The Parties, With A Practical Construction Of The Effect Of Those Obligations, And With This Court's Decision In Commissioner v. Brown.

1. Lyon is, and will remain until full payment, solely liable on the $7.14 million permanent loan from New York Life Insurance Company. The Government dismisses this as unimportant because rent payments will cover the balance of the note, and Worthen obligated itself to pay rent throughout the 25-year period in which the loan is to be paid back. But the loan was certainly far from unimportant to Lyon. Mr. Lyon expressed shock at the idea that his company would make itself liable on a loan of such size merely as an accommodation party or as a straw man to any one. He stressed the necessity of showing the liability on the firm books (with its consequent impact on firm standing and credit) and noted in particular the close watch that Lyon's distributors, RCA and Whirlpool, kept over its books (App. 259). If Worthen defaults, Lyon remains liable on the loan and must pay it whether the rent comes in or not. (P.Exs. 20, 26 at App. 443, 523). The Government disregards this possibility, though the parties dealt with it at length. In effect, the Government contends that Lyon has nothing at risk because the rent payments flow through to cover Lyon's loan obligations.[20] By disregarding Lyon's independ-

[20] This, of course, is a standard incident of any long term lease. The lessor will always look to the rental during the primary term of the lease to cover its liability on its own financing obligations. And any lender will always insist that the rental payments be sufficient to cover the payments on its loan.

ent liability, the Government is able to argue that only Lyon's initial equity investment of $500,000 is ever at risk and that Lyon will surely recover at least that amount.

This "flow-through" contention is quite similar to the position which this Court rejected in the case of *Commissioner* v. *Brown*, 380 U.S. 563 (1965). In *Brown* the family-owned Brown Company was sold to the New York Cancer Institute, a tax exempt organization for a price of $1.3 million, paid by the charity's note. The Institute then leased the assets of the company to a second corporation owned by the Brown family's lawyers and having the same operating personnel as the original Brown Company. The new company paid the Institute 80% of its gross profits for the use of the leased assets. The tax exempt organization agreed to apply 90% of this amount to the $1.3 million note owed to the Brown shareholders.

The benefit from the point of view of the Brown shareholders was that before the transaction the profits which resulted from the use of the assets were taxable to them as ordinary income. After the transaction they received only 72% of those profits, but: the new company was able to deduct the rentals paid to the Cancer Institute; the Cancer Institute paid no taxes on the monies it received because it was tax exempt; and the Brown shareholders treated the 72% of profits which they received as capital gain on the sale of the company, subject to capital gains tax rates rather than ordinary income rates.

The Commissioner asserted that the transaction was a sham because the Brown Company personnel and shareholders retained so much economic interest and control over the assets in question.

The Tax Court rejected the Commissioner's contention noting that the parties had bargained in good faith at arms length; that the price was in a reasonable range with the assets involved; that there was a real exchange of economic benefits in the transactions; and that the Institute was found to be motivated to a great extent by the residual value of the assets. The court of appeals affirmed.

Before this Court, the Commissioner shifted his ground somewhat. He argued that the risk of the transaction remained completely on the seller, the Brown Company, since the Institute had invested nothing itself in buying the assets and retained no independent liability for the purchase price if there were no profits. This Court rejected the argument that there was no sale because there was no risk shifting and that there was no risk shifting because the purchase price came only from income.

The Government is pressing the same argument here that the Court rejected in *Brown* even though (1) Lyon's obligation to pay the note to New York Life is unconditional, and (2) Lyon retains substantial elements of risk, and has interests in the building which are independent of the interests of either Worthen or New York Life.

From the point of view of economic substance the present case seems similar and indeed much stronger than *Brown*, not only because Lyon takes on independent risks, but also because the sale-leaseback's utility does not depend upon the tax consequences.

2. Moreover, there is a strong likelihood that the lease will terminate after twenty-five years, and that Lyon will then have full ownership of the building. Worthen

has no obligation after twenty-five years, unless it exercises an option to renew. Substantial testimony below indicated that Worthen may well seek new quarters at the end of 25 years (App. 171-172; 241-242); the combination of Worthen's capital needs and its need for up-to-date accommodations may leave Lyon in complete control of the building for the remaining 50 years of the ground lease.[21] The president of the bank testified that 25 years was about the maximum a bank could stay in one place (App. 172) and the bank is free to leave the building after 25 years, or at the end of any subsequent 5 year renewal period.

In any event, under the lease, Lyon will come into absolute control of the building at the end of all the lease and renewal periods. In the final negotiation over the terms of the sale and leaseback and related agreements, Frank Lyon Company bargained for and got a 10-year extension of the ground lease beyond the period covered by Worthen's options to renew. The ground rent drops from $250,000 per year to $10,000 per year for the remaining 10 years of the ground lease. Even if Frank Lyon does not come into control earlier, during this 10-year period the company will be free to deal with the building at a drastically reduced ground rent and to use it as it pleases. The improvements made by Worthen, which necessarily would be extensive, would then be retained by Lyon (P.Ex. 19 section 8.1 at App. 382-383). Lyon anticipated an income from the building of roughly $2.9 million dollars over this ten-year period. (P.Ex. 36, at App. 595; App. 35, 51.)

[21] Lyon indicated that increasing equity in the Worthen building was an important factor in buying the building. App. 50.

Accumulated appreciation or depreciation of the building will be borne by Lyon whenever it comes into total control in renting and operating the building or in making the repairs or arrangements necessary to do so. Neither the court of appeals nor the Government has dealt in any satisfactory way with this 40-year period of potential complete control by Lyon, or the 10-year period of absolute control by Lyon over the building and over all the subsequent improvements made by Worthen. It is certainly inconsistent with characterization of Lyon as a mere conduit.

3. There has been some dispute in this case about residual interests in the building at the end of the ground lease. Lyon maintains that it will continue to own the building at the end of the lease,[22] and the Government has maintained that the building will revert to Worthen: that Worthen has retained control throughout the 65-year period by its options, and by reverter at the end of the ground lease. The court of appeals, while indicating that it need not decide the issue, pronounced that Lyon's claim was "dubious." (Pet. App. 27a, n.6.) The issue is significant because if Lyon is the owner of the building, Lyon will be entitled to sell or lease the building at fair value. If it is unable to come to an arrangement with Worthen on the ground lease, it will be entitled to an equitable adjustment under Arkansas law. Moreover, Lyon's residual interest in the building is, like the 10-year period in which Lyon is entitled to deal with the building free of the lease, totally inconsistent with the picture of Lyon as an accommodation party or straw man.

[22] This was Lyon's explicit understanding at the time it entered the arrangement, based upon legal advice from counsel. App. 36.

The common law rule and Arkansas case [23] relied upon by the Government in its brief in opposition to the petition for certiorari stand for a proposition—that improvements by a lessee revert to the owner of the land at the end of the lease unless the lease provides otherwise—which is simply not applicable when the improvement has been specifically sold, without reservation of rights, to the lessee; nor is there any equitable reason why it should. Here the building was constructed by Worthen as the owner of the land and sold separately from the land by a sales agreement and a general warranty deed to Lyon as the lessee of the land without any reservations of reversionary rights, in clear recogtion of the separate ownerships of the land and the building. (P.Ex. 25 at App. 508.) This negates any suggestion that Lyon as lessee of the land (or Worthen as lessor) constructed improvements on the demised premises with the intention, silent or explicit, that the improvements would automatically revert to the ground lessor on the termination of the lease.[24] The instruments executed by Worthen and Lyon not only reflect a clear recognition of Lyon as owner of the building, but also a clear intent that title to that building would return to Worthen only in the event Worthen exercised one of its options to purchase.

Arkansas law clearly recognizes that one person may own the leased land and another may own the improvements thereon. In *Stirman* v. *Cravens,* 33 Ark. 376

[23] Williams v. Kirby School District No. 32, 207 Ark. 458, 181 S.W. 2d 488, 490 (1944).

[24] Compare the treatment of improvements in the building lease, P.Ex. 19, Sec. 8.1, at App. 382-83, which provides explicitly that improvements made become the property of the building lessor, Lyon.

(1878), the Arkansas Supreme Court resolved the dilemma of dual ownership of the land and building after the termination of the lease by ordering the property sold and the purchase price divided in proportion to value. *Stirman* followed an earlier case of *Witherspoon* v. *Nickels,* 27 Ark. 332 (1871), and was cited with aproval in *Butler* v. *Adler-Goldman Commission Company,* 62 Ark. 445, 450, 35 S. W. 1110, 1111 (1896), and in *Storthz* v. *Sanger,* 108 Ark. 154, 161, 156 S.W. 1020, 1022 (1913). It has never been overruled or questioned.

The Government and court of appeals have implied that Worthen retained title to the land in order to ensure complete control of the building through its recovery on the expiration of the Ground Lease. To the contrary, Worthen first planned to sell and leaseback both the land and the building (P.Ex. 2 and 5 at App. 322, 328), and the State Banking Department required that Worthen have an option to repurchase the land and building after 15 years at a presently "agreed upon figure" for the building and "the land at the cost at which it was" acquired. (P.Ex. 6 at App. 336-37.) [25] During subsequent negotiations with potential investors, the sale of the land under the building was eliminated from the proposed sale-leaseback transaction at the suggestion of Eastman Dillion, Union Securities Co. (one of the potential investors), solely in order to simplify the establishment of equitable option prices for the building alone on the various option dates (P.Ex. 39 at App. 601).

Worthen conveyed to Lyon absolute title to the building by a general warranty deed subject only to options

[25] It is questionable whether the State Bank Department would have approved an option price based on fair market value rather than an "agreed upon figure" or dollar value.

to repurchase. The district court found that "it is most unlikely that Worthen will exercise the option [to repurchase] at the end of eleven years, or, indeed, at the end of any subsequent option period" (Pet. App. A 2a). It is clear under Arkansas law that the building will not revert to Worthen at the end of the 75-year Ground Lease. Consequently, it is highly unlikely that ownership of the building will ever revert to Worthen, in which case Lyon is clearly entitled to the deduction for depreciation.

4. Various other features of the lease transaction indicate that Lyon was not a mere conduit. For example, Lyon could at any time sell the building to another purchaser. Mr. Lyon testified that he had been approached to do so on several occasions and had refused because he thought the investment a good one. (App. 261-62, P.Ex. 51 at App. 687.) [26]

Moreover, the conduit theory adopted by the court below will in no event be applicable to the interest paid by Lyon to FNCB on the interim loan during the period of construction. There is no payment by Worthen to Lyon which can, in any sense, be regarded as flowing through Lyon from Worthen to FNCB.

D. Commissioner v. First Security Bank Of Utah Precludes A Finding That Worthen Owns The Bank Building For Tax Purposes.

In determining that Worthen is the owner of the Bank Building for tax purposes, when state and federal banking regulations prevented Worthen from being the owner, the Commissioner ignored the effect of

[26] Lyon agreed to protect Worthen from an unacceptable owner coming into control of the Frank Lyon Company. P.Ex. 50. But this did not cover ownership of the building itself.

this Court's holding in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972).

In *First Security Bank*, the Commissioner attempted to allocate income to the taxpayer based on its activities in referring borrowers to insurance companies owned by the same holding company as the bank. The holding company also controlled a management company, an insurance agency, and an insurance company. The Commissioner acted pursuant to § 482 of the I.R.C. —which allows the Commissioner to reallocate income among businesses owned by the same interests if he determines it is necessary to prevent misallocation among these businesses and evasion of taxes. The Bank did not receive any commissions for this referral because it was prohibited by law from doing so. Nonetheless, the Commissioner allocated amounts equivalent to normal commissions to the bank and away from the related companies which retained those amounts. The Court rejected this attempt.

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving." 405 U.S. at 403.

The present case involves deductions rather than income, but it would similarly be illegal for Worthen Bank to own the building here in question. The Commissioner's action here, as there, amounts to a denial that banking regulations have tax "substance." The banking regulations in each case serve to make it clear that the arrangement in which the taxpayer was involved was not a device merely to avoid taxes, but an arrangement with an independent justification and rationale.

Nor were the banking requirements in this case merely formal. Mr. Wyrick of the Federal Reserve System indicated to Worthen that ownership of the bank building by a wholly-owned subsidiary would not satisfy Federal Reserve requirements because it would be the practical equivalent of ownership by Worthen itself. See also P.Exs. 4 and 38 at App. 326, 599; App. 133-34, 139-40.

IV. THE TRANSACTION SHOULD BE TAXED IN ACCORDANCE WITH THE DETAILED FACTUAL FINDINGS OF THE DISTRICT COURT.

A full appreciation of the facts is necessary to determine the "economic substance" of a transaction. In denying interest and depreciation deductions to Lyon, the court of appeals evaded the specific factual findings of the district court.

The trial court found that the rents were reasonable throughout the period of the lease (Pet. App. 13a, 5a-6a), and rejected the notion that Worthen was acquiring an equity in the building through its rental payments. (Pet. App. 2a, n.2.) The trial court also found that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates. (Pet. App. 6a.) The trial court further concluded that it was highly unlikely as a practical matter that any purchase option would ever be exercised. (Pet. App. 2a, n.2.) Finally, the trial court made the ultimate finding that this was in fact a sale and leaseback. Specifically, the Court said (Pet. App. 1a-2a):

> "After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws."

These findings were not based on speculation or on a conclusory reading of the documents alone. The trial court heard specific supporting testimony concerning—

1. the motives of the parties upon entering into the transaction; see footnotes 12 and 13, *supra*, pp. 20-21.

2. the capital and business circumstances of each (App. 19-21, 48-50, 127-28, 130, 131, 135, 137, 163, 166-67, 213, 218-19, 238);[27]

3. the nature and details of the negotiation (among the parties, the lenders, and the banking authorities) (App. 23-29, 85-86, 91, 142-146, 148-49, 150, 162-164, 272-273, 311);

---

[27] Mr. Dover, who represented New York Life Insurance Company in the negotiations, testified that the negotiations took so long—from December 1967 to May 1968 even though the basic format had been agreed upon—because:

> "Well, there was just considerable give and take, bargaining, negotiating among the parties. I assume these documents are in evidence. There were volumes of documents and were negotiated chapter and verse, paragraph by paragraph, almost word for word." App. 85-86.

4. the comparability of the rents and options to market prices (App. 31, 226-29, 235-36, 239-40, 241); and

5. the practical likelihood of various eventualities as they presented themselves to the parties at the time they entered into the transaction (App. 35-36, 165-173, 213, 250-51, 260).[28]

It also explored in detail the nature of the overall relationship between Lyon and Worthen and the numerous documents. This factual display fully supported Lyon's contentions about the nature of the transaction.

The Government offered no testimony whatever on the "reasonableness" of the various option prices and rentals; it offered no testimony which contradicted the parties' picture of the nature and motivations of their transaction; and it offered no factual display whatever about the prospects of a building such as Lyon's, or about the real estate market the building was in. The only testimony offered by the Government was that of the revenue agent who admitted to little experience with the real estate transactions, and next to none in the field of sales and leaseback. If he had any particular

[28] Both Mr. Penick of Worthen Bank and Frank Lyon Company emphatically denied that there was any agreement of any sort that Worthen would exercise one of its options and expressed doubt any option would ever be exercised. App. 165-172 and 260. As Frank Lyon said:

> "At that time I didn't think they could exercise it. I still hold that opinion. Of course they have final say on that, not me. We went into it on the basis they couldn't then. I don't think they could now. I don't know as much about it as they do, however." App. 260.

knowledge of the market and prospects for office buildings in Little Rock, it does not appear in the record."[29]

The court below evades the specific factual findings of the District Court by invoking the "substance over form" doctrine and characterizing entitlement to depreciation deductions as a legal question which is to be determined by interpretation of "undisputed written documents." The intent of the parties, the Court of Appeals said, is only relevant insofar as it affects the allocation of ownership interests which is spelled out in the contract documents. It is this allocation of interests which is "the substance of the transaction."

Lyon does not seek to controvert the long established principle of tax law that substance is to prevail over form. However, determination of the "substance" of a transaction of this sort has been consistently interpreted to require a factual appreciation of the importance of the ownership interests which are being allocated. *See, e.g., American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974); *Northwest Acceptance Corp.* v. *Commissioner*, 500 F.2d 1222 (9th Cir. 1974); *cf. Commissioner* v. *Duberstein*, 363 U.S. 278, 289 (1960).

[29] The situation which confronted the district court is similar to that addressed in *Kearney & Trecker Corp.* v. *United States*, 195 F. Supp. 158, 162 (E.D. Wis. 1961):

> "These findings of reasonableness of both the option prices and the rental are not only affirmatively supported by the credible testimony and documentation, but negatively by the failure on the part of the United States to produce any witness who would state that the option prices were so low, when compared to the market value of the leased property, as to indicate that lessees exercising their options to purchase had previously acquired an equity in that property, or that rental payments were so high when compared with the actual use value of the leased property, as to indicate that they were, in reality, payments on an installment purchase. Under these circumstances we must hold that no equity is being acquired."

As the Tax Court said in *Reade Manufacturing Co.*, 32 T.C.M. 1225 (1973):

> "[T]he proper standard for determining the Federal income tax consequences for this transaction is the intent of the parties and the substance of the transaction resulting from their intent. The resolution of this narrow issue, purely a factual one, must be determined from all the facts and circumstances surrounding the agreement when it was made." 32 T.C.M. at 1230.

The court below maintains, in effect, that it can determine whether documents which purport to be a lease are in actuality a sale or a loan by a purely "legal" reference to the documents themselves regardless of factual determinations whether the option price was substantial and fair, whether the rentals for the property represent good faith estimates of rental value (as opposed to purchase installments or loan repayment), or whether as a factual matter the purported lessee is going to exercise its options and gain full ownership.

Although the Government and court of appeals invoked the "substance over form" doctrine, the assertion that an appellate court can determine the substance of the transaction solely by reference to the formal documents and disregard factual findings below is totally contrary to the rationale of that doctrine and to Rule 52(a) Fed.R.Civ.Pro.[30] As this Court stated in *Helvering* v. *Lazarus & Co.*, *supra:* "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." (308 U.S. at 255.) The court below looks beyond the label of the transaction—but not so far as the economic reality of the interests allocated.

[30] "If the transactions were bona fide leases and the taxpayer remained the owner of the equipment, then it was entitled to a deduction for depreciation, Int. Rev. Code of 1954 § 167, and an investment credit, Int. Rev. Code of 1954 § 38, both of which the taxpayer had taken. It would not have obtained those tax advantages were the agreements in question contracts of sale or conditional sales. The issue is essentially a factual one. As the Tax Court pointed out, '[t]he factual issue presented here is an extremely close one, making the decision difficult.' That court resolved the contest in favor of the taxpayer, holding that the agreements were leases. Weighing the same evidence we might well have decided the case differently notwithstanding the decision in *Lockhart Leasing Co.* v. *United States*, 446 F.2d 269 (10th Cir. 1971), upon which the Tax Court so heavily relied. But our standard of review requires us to affirm unless the decision is 'clearly erroneous.' *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960)." *Northwest Acceptance Corp.* v. *Commissioner*, 500 F.2d 1222 (other citations omitted).

The conflict between the approach of the court below and previous courts of appeals is shown most clearly by consideration of the recent Fourth Circuit case of *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974). In *American Realty Trust*, the Government pressed two contentions on the court. First, Government counsel suggested that the proper characterization of the substance of the transaction was "essentially a factual matter," and that *American Realty Trust* had not proven by a preponderance of the evidence that the transaction involved was a bona fide sale and leaseback and not a financing arrangement. Second, the Government maintained that the question of the bona fides of a sale-leaseback was a legal question and could be decided as such on appeal without regard to the findings of the court below. In rejecting both

contentions, the court relied heavily on the facts as found by jury verdict in the district court. With regard to the issue of the preponderance of the evidence the court stated:

> "We emphasize that appellate review of a jury verdict presents no occasion for the reviewing court to sift and weigh competing factual assertions, to draw its own inferences from contradictory evidence, or to choose between the more persuasive of two plausible but contradictory inferences. It is the jury which weighs the contradictory evidence and inferences and draws the ultimate conclusion as to the facts." 498 F.2d at 1198

With regard to the second contention that "this court may consider the matter *de novo* as it were," the Fourth Circuit noted that the legal conclusion of the bona fides of a sale and leaseback transaction is necessarily grounded in underlying findings of fact.

> "We are not persuaded that the ART-Helmsley transaction must necessarily be characterized as a sham, as less than *bona fide*, or as, 'in substance,' a secured loan. There was considerable evidence in the record to the effect that the intent of the parties, acting in complete good faith, was to undertake a sale to ART with a subsequent leaseback to Helmsley. There was testimony tending to show that Helmsley decided to exercise his option because of the sudden availability of 'wrap-around' financing, not because there was any 'economic compulsion' to repurchase inherent in the deal with ART. Moreover, there was testimony that the agreed upon purchase price—$7,000,000—was 'fair,' and not an unduly low one as the government asserts. These factors appear to us to provide sufficient basis for the conclusion that the sale-and-leaseback was in substance a *bona fide* transaction. This is not to suggest of course that we believe that tax considerations played no part whatsoever in the planning of the deal. Merely because tax planning may have preceded a transaction, or because tax savings have flowed from it, we are not constrained to characterize the entire event as primarily, or even substantially, a tax avoidance device." 498 F.2d at 1199

This treatment of the specific issue of the bona fides of a sale-leaseback merely reflects the general standard of review under Rule 52(a) Fed.R.Civ.Pro. that the factual findings of the district court, even factual inference from undisputed facts, must not be overturned unless clearly erroneous. This Court has been consistent and emphatic on this point. *See Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960); *see also United States* v. *U.S. Gypsum Co.*, 333 U.S. 364, 394 (1948); *United States* v. *Singer Manufacturing Co.*, 374 U.S. 174, 194 n.9 (1963); 9 Wright & Miller, Federal Practice and Procedure §§ 2587; 2589 (1971). *See also, Northwest Acceptance Corp.* v. *Commissioner*, 500 F.2d 1222 (9th Cir. 1974), *supra*, note 30. This rule applies to cases tried on documentary as well as oral evidence. See *Lundgren* v. *Freeman*, 307 F.2d 104, 113-115 (9th Cir. 1962); *Wright & Miller, supra*, § 2587.

As Judge Brown said in *Horton* v. *U.S. Steel Corp.*, 286 F.2d 710, 713 (5th Cir. 1961), the trial court's findings "come here well armed with the buckler and shield of F.R.Civ.P. 52(a) . . ." Nor should Rule 52(a) "be construed to encourage appeals that are based on the hope that the appellate court will second-guess the trial court."

The syllogism implicit in the holding below—substance is a matter of interpretation of documents, interpretation of documents is a legal matter, therefore,

CONCLUSION

Lyon's entitlement to the deductions for depreciation, interest, and interim expenses, is supported by the language of the statute, by considerations of tax policy, economic reality, and proper appellate review. The judgment of the court of appeals should be reversed and the district court's decision should be affirmed by this Court.

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substance of the transaction must be purely a legal determination—is blankly specious. An appellate court attempting *de novo* to reevaluate the "substance" of a transaction on appeal mistakes the proper bounds of appellate review, and, as here, is very likely to mistake the nature of the transaction under consideration as well.

Lyon's position is a simple one, which accords with the case law and normal appellate practice: appreciation of the "substance" of a transaction for tax purposes requires factual determinations about the intent and circumstances of the parties, and about the nature of the interests created by the transaction. On review, appellate courts must give appropriate deference to the factual findings on these matters by the court which tried the case.

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No. 76-624

In the Supreme Court of the United States

OCTOBER TERM, 1977

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	3
A. The factual background	3
B. The terms of the sale-and-leaseback arrangement	11
1. Agreements between petitioner and Worthen	11
2. Construction financing agreements	16
3. Permanent financing agreements	17
C. The proceedings below	18
Summary of argument	21
Argument	26
I. The sale and leaseback arrangement in this case was a financing transaction under which petitioner did not have any significant ownership interest or investment in the building that would entitle it to tax deductions for mortgage interest and depreciation	26
A. The economic substance of sale and leasebacks is controlling for federal tax purposes	26
B. *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252, controls this case	32
C. The bargain terms of the lease renewal arrangement demonstrate that it is a financing transaction and not a true sale	44
D. Since petitioner is not the true owner of the building, it cannot claim deductions for mortgage interest or depreciation	52
1. Mortgage interest	53
2. Depreciation	56
E. The arrangement in this case was not the product of arms-length bargaining	58

Argument—Continued Page

II. The court of appeals correctly held that the federal tax consequences of a sale and leaseback present a question of law ---- 66

Conclusion ---- 71

CITATIONS

Cases:

ABKCO Industries, Inc. v. *Commissioner*, 482 F. 2d 150 ---- 68

American National Bank of Austin v. *United States*, 421 F. 2d 442, certiorari denied, 400 U.S. 819 ---- 26, 27

American Realty Trust v. *United States*, 498 F. 2d 1194 ---- 26, 43, 68, 69, 70

Benton v. *Commissioner*, 197 F. 2d 745 ---- 68

Breece Veneer & Panel Co. v. *Commissioner*, 232 F. 2d 319 ---- 43

Carlton v. *United States*, 385 F. 2d 238 ---- 68

City National Bank Building Co. v. *Helvering*, 98 F. 2d 216 ---- 34

Commissioner v. *Brown*, 380 U.S. 563 ---- 53

Commissioner v. *Court Holding Co.*, 324 U.S. 331 ---- 27

Commissioner v. *Danielson*, 378 F. 2d 771, certiorari denied, 389 U.S. 858 ---- 64

Commissioner v. *Duberstein*, 363 U.S. 278 ---- 27, 60

Commissioner v. *First Security Bank of Utah*, 405 U.S. 394 ---- 60, 61

Commissioner v. *H. F. Neighbors R. Co.*, 81 F. 2d 173 ---- 42

Commissioner v. *P. G. Lake, Inc.*, 356 U.S. 260 ---- 27

Commissioner v. *Sunnen*, 333 U.S. 591 ---- 27

Commissioner v. *Tower*, 327 U.S. 280 ---- 27

Copperhead Coal Co. v. *Commissioner*, 272 F. 2d 45 ---- 64

Corliss v. *Bowers*, 281 U.S. 376 ---- 26

Deputy v. *duPont*, 308 U.S. 488 ---- 54

F. & D. Rentals, Inc., v. *Commissioner*, 44 T.C. 335 ---- 64

F. and R. Lazarus & Co. v. *Commissioner*, 32 B.T.A. 633 ---- 33, 49

Franklin, Estate of v. *Commissioner*, 544 F. 2d 1045 ---- 26, 43, 68

Frenzel v. *Commissioner*, 1963 P-H Memo TC, par. 63,276 decided October 7, 1963 ---- 43, 49

Cases—Continued

Page

Frito-Lay, Inc. v. *United States*, 209 F. Supp. 886 ---- 43

Helvering v. *Clifford*, 309 U.S. 331 ---- 27

Helvering v. *F. & R. Lazarus & Co.*, 308 U.S. 252 ---- 21, 27, 32, 34, 55, 57, 66, 68

Holbrook v. *Commissioner*, 450 F. 2d 134 ---- 36

Iowa v. *McFarland*, 110 U.S. 471 ---- 28

Leeds and Lippincott Co. v. *United States*, 276 F. 2d 927, affirming an unreported decision of September 1, 959 (D. N.J.) ---- 43

Levinson v. *Commissioner*, 45 T.C. 380 ---- 64

M. DeMatteo Construction Co. v. *United States*, 433 F. 2d 1263 ---- 57

Midler Court Realty, Inc. v. *Commissioner*, 521 F. 2d 767 ---- 49

Mt. Mansfield Television, Inc. v. *United States*, 239 F. Supp. 539, affirmed, 342 F. 2d 99, certiorari denied, 382 U.S. 818 ---- 49

Nelson v. *Commissioner*, 281 F. 2d 1 ---- 55

Oesterreich v. *Commissioner*, 226 F. 2d 798 ---- 26, 43, 68

Old Colony R. Co. v. *Commissioner*, 284 U.S. 552 ---- 54

Starr's Estate v. *Commissioner*, 274 F. 2d 294 ---- 43, 49

Stirman v. *Cravens*, 33 Ark. 376 ---- 42

Union Planters National Bank of Memphis v. *United States*, 426 F. 2d 115, certiorari denied, 400 U.S. 827 ---- 26, 67–68

United States v. *Henderson*, 375 F. 2d 36 ---- 68

United States v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808 ---- 46

United States v. *Ludey*, 274 U.S. 295 ---- 56

United States v. *Winthrop*, 417 F. 2d 905 ---- 67

United States Fidelity & Guaranty Co. v. Commissioner, 40 B.T.A. 1010 ---- 55

William v. Kirby School Dist. No. 32, 207 Ark. 458, 181 S.W. 2d 488 ---- 42

Williamson v. *Berry*, 8 How. 495 ---- 28

World Publishing Co. v. *Commissioner*, 299, F. 2d 614 ---- 57

Statutes, rule and regulations:	Page
Internal Revenue Code of 1954 (26 U.S.C.):	
Section 162(a)	31
Section 162(a)(3)	38
Section 163	2, 31
Section 163(a)	54
Section 167	3, 31
Section 167(g)	58
12 U.S.C. 371d	5, 61
Fed. R. Civ. P. 52(a)	66, 67
12 C.F.R. 265.2f(7)	5
Treasury Regulations on Income Tax, Section 1.163-1(b) (26 C.F.R.)	56
Miscellaneous:	
American Institute of Real Estate Appraisers, *The Appraisal of Real Estate* (6th ed.)	40
C.R.C., *Standard Mathematical Tables, Interest Tables—Present Value of Annuity*	40
Cary, *Corporate Financing Through the Sale and Lease-back of Property: Business, Tax, and Policy Considerations*, 62 Harv. L. Rev. 1 (1948)	44, 58, 59, 64
FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976)	49-50, 52
Gant, *Illusion in Lease Financing*, 37 Harv. Bus. Rev. (No. 2) 121 (1959)	50
Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 Real Estate Law. J. 664 (1974)	50
Rev. Proc. 72-10, 1972-1 Cum. Bull 721	64
Rev. Proc. 75-21, Sec. 4(2) 1975-1 Cum. Bull. 715	49, 59
Rev. Rul. 55-540, 1955-2 Cum. Bull. 39	59
Rosenberg and Weinstein, *Sale-leasebacks: An analysis of these transactions after the* Lyon *decision*, 45 Journal of Taxation 146 (September 1976)	44, 49, 69

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-624

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum letter opinion and findings of fact and conclusions of law of the district court (Pet. App. A 1a-14a) are not reported. The opinion of the court of appeals (Pet. App. B 15a-30a) is reported at 536 F.2d 746.

JURISDICTION

The judgment of the court of appeals was entered on May 26, 1976 (Pet. App. C 31a). On August 6, 1976, the court of appeals clarified the final sentence of its opinion, but otherwise denied a petition for rehearing by petitioner with suggestion for rehearing

en banc (Pet. App. D 32a–33a). The petition for a writ of certiorari was filed on November 3, 1976, and was granted on February 22, 1977. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the transfer of title to a building to petitioner and petitioner's simultaneous long-term lease of the building back to the transferor was a financing transaction under which petitioner did not have any significant ownership interest or investment in the building that would entitle it to income tax deductions for mortgage interest and depreciation, where: (1) the lessee had an unconditional obligation during a 25-year term to pay rent exactly equal to the mortgage payments and had the option to extend the lease for 40 years at sharply reduced rents; (2) the lessee had the option to reacquire title to the building for an amount that was unrelated to its fair market value but was the sum of the cash advanced by petitioner, plus interest, and the balance of the mortgage loan; and (3) the lessee retained title to the underlying land.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

STATEMENT

This case involves the federal tax consequences of a sale-and-leaseback transaction in which petitioner took title to a building under construction by the Worthen Bank & Trust Company ("Worthen") of Little Rock, Arkansas, and simultaneously leased the building back to Worthen for long-term use as its headquarters and principal banking facility.

The pertinent facts are undisputed and are established by the trial testimony and the documentary evidence.

A. THE FACTUAL BACKGROUND

1. Petitioner is a closely-held corporation primarily engaged in distributing household electronic products (I–A. 19–20). In 1962, the Worthen Bank began to consider moving to new quarters in downtown Little Rock. Worthen thereafter engaged a real estate consulting firm which recommended that Worthen construct a new banking facility on urban renewal land

located in the downtown area of the city. In 1966, Worthen submitted a development plan to the Little Rock Housing Authority, the owner of the urban renewal property, and offered to purchase the parcel for $1,425,299.95 (I–A. 124–126, 129; Pltf. Ex. 1, II–A. 313–315). Prior to acquiring the land, Worthen had hired an architectural firm to prepare working drawings of a proposed headquarters building, and also entered into construction contracts (Pet. App. B 16a).

Worthen acquired the land and began construction on September 15, 1967. At that time, Worthen had already obtained a verbal commitment from First National City Bank of New York ("City Bank") for interim construction financing of the project (I–A. 129–130; Deft. Ex. 16, II–A. 742–748). As a result of its extensive discussions with various mortgage bankers, Worthen had also received a number of proposals for permanent financing (I–A. 126–127, 202–205; Deft. Ex. 16, II–A. 742–748).

Worthen originally hoped to finance the estimated $9 million cost of the land, building and parking facility by itself. Thus, in seeking approval for the project from the Federal Reserve Bank, Worthen showed the proposed building as an asset on a *pro forma* balance sheet (Pltf. Ex. 1, II–A. 320). However, the regulations of the Arkansas State Bank Department and the Federal Reserve Board required Worthen, as a state bank subject to their supervision, to obtain permission from them to invest an amount in banking

premises in excess of its $4,000,000 capital stock or 40 percent of its capital stock and surplus (I–A. 131).[1] See 12 U.S.C. 371d; 12 C.F.R. 265.2(f)(7). Thus, Worthen began to consider alternative methods of financing that would permit it to characterize itself on its books as a tenant rather than the owner of the building (I–A. 189; Deft. Ex. 13, II–A. 707).[2]

2. In September 1967, shortly before construction was started, Worthen formulated a new financing

[1] As of June 30, 1967, Worthen's capital stock was $4,000,000 and its surplus was $5,000,000 (Pltf. Ex. 1, II–A. 318). During the period in which the building was under construction, Worthen became a national bank under the supervision and control of the Comptroller of the Currency (I–A. 196–197).

[2] Worthen first considered creating a wholly-owned real estate subsidiary to hold title to the building and to lease it to Worthen (Pltf. Ex. 1, II–A. 313–314; Deft. Ex. 13, II–A. 707). Under this plan, the subsidiary would raise the necessary funds by issuing $4,000,000 in debentures and borrowing $5,000,000 under a conventional mortgage loan (I–A. 132–133; Deft. Ex. 13, II–A. 707; Deft. Ex. 16 I–A. 742–748). But this plan was abandoned because (1) the Federal Reserve Bank advised Worthen that an investment by such a subsidiary would be considered to be Worthen's own investment in banking premises (I–A. 133–134; Pltf. Ex. 37, II–A. 597); and (2) there was no market for the proposed debentures because of the interest rate limitations Arkansas law then imposed on state banks (I–A. 135; Pet. App. A 4a).

Counsel further advised Worthen that the Internal Revenue Service would regard Worthen as the owner of the building despite the fact that the subsidiary would hold title to it. In the opinion of counsel, the Service would treat the lease as a security agreement for the loan obtained by Worthen. The result of such a determination would be that Worthen could claim deductions for depreciation and interest but would not be allowed deductions for the rental payments to its subsidiary (Deft. Ex. 14, II–A. 708–715).

plan which involved a sale-and-leaseback arrangement (Pltf. Exs. 2, 3 and 4, II–A. 322–326; I–A. 136). Under this proposal, an institutional investor would purchase the land and construct the building and lease them to Worthen on a long-term basis.[3] Worthen would have an option to purchase the building after 15 years at an agreed-upon figure.[4] Worthen itself would make no capital investment in the building but would bear the cost of constructing the parking garage. On September 13, 1967, the Federal Reserve Bank advised Worthen that it had no objection to this proposal[5] (Pltf. Ex. 4, II–A. 326–327).

While the plan as initially approved by the Federal Reserve Bank called for sale of the land to an outside investor who would construct the building,

[3] Counsel advised Worthen that its proposed lease-and-option-to-purchase arrangement with an institutional investor would be recognized by the Internal Revenue Service as a "valid lease for Federal income tax purposes; and particularly so if the institutional investor finances the construction so that there is not a sale followed by a leaseback" (Deft. Ex. 15, II–A. 735–736). Counsel further emphasized that "[t]he rental payments appear to be the fair rental value * * * and most important, the option price will be substantially equal to the fair market value of the land and building at the time of its exercise" (*id.* at II–A. 737).

[4] The Arkansas State Bank Department required that such a leaseback arrangement provide for a repurchase-option at the end of the 15th year, but did not otherwise specify the terms of the agreement (Pet. App. A 4a).

[5] Worthen obtained approval from the Arkansas State Bank Commissioner for a similar plan, which called for Worthen itself to construct the building and then to enter into a sale-and-leaseback arrangement with an outside investor (Pltf. Exs. 5 and 6, II–R. 328–337).

Worthen wanted to maintain exclusive control and responsibility over the details of the building (I–A. 156–157). Worthen also recognized that it could save an estimated $125,000 in sales taxes on the materials to be incorporated in the building if it constructed the building itself because it was not subject to the Arkansas sales tax. (I–A. 32, 117–118; Deft. Ex. 16, II–A. 744). Thus, Worthen acquired title to the land and commenced construction work itself on September 15, 1967, prior to its completion of final financing arrangements (I–A. 128–130).[6]

Worthen thereafter commenced negotiations with the investment banking firms of Goldman, Sachs & Company, White, Weld & Co., Eastman Dillon, Union Securities & Company, and Stephens, Inc., with regard to providing $7,500,000 in financing required under the proposed sale-and-leaseback arrangement (I–A. 142; Pet. App. A 4a). Four of these firms made specific proposals to Worthen regarding the sale-and-leaseback plan of financing the new bank headquar-

[6] The Federal Reserve Bank, however, advised Worthen that it could not approve an arrangement under which Worthen built the building if, at any time, the interim construction financing shown on Worthen's balance sheet exceeded its capital stock of $4,000,000 (I–A. 139–140; Pltf. Ex. 38, II–A. 599–600). Worthen gave its assurances that it would not exceed this limitation (Pltf. Ex. 7, II–A. 338). Worthen thereafter adopted a plan by which the building was sold piece by piece to petitioner as it was constructed, so that the entire building never appeared on Worthen's books (I–A. 117–118; Pltf. Ex. 43, II–A. 620–621; Pet. App. B 18a n. 2).

ters (Pltf. Ex. 9, II–A. 340–343; Pltf. Ex. 10, II–A. 344–345; Pltf. Ex. 39, II–A. 601–608).[7]

In late October 1967, Worthen obtained a commitment from the New York Life Insurance Company to provide $7,140,000 of permanent mortgage financing on the building, conditioned upon its approval of the party nominated by Worthen to hold title to the

[7] Goldman, Sachs & Company submitted a sale-and-leaseback proposal involving both the land and building, which called for rentals of $571,430 annually over a 25-year primary term, based on a 6¾ percent interest rate on the amount financed (Pltf. Ex. 9, II–A. 340–343). Under this proposal, Worthen would enter into a "net" lease and have the same responsibilities "as if it had complete ownership" (Pltf. Ex. 9, II–A. 341). At the end of the primary term of the lease, Worthen would have the option to repurchase the property for an amount equal to the greater of its fair market value or 20 percent of the original cost of the property. Worthen would also have options to repurchase the property at its fair market value during the extended terms of the lease (Pltf. Ex. 9, II–A. 343).

Stephens, Inc. made a joint proposal with Eastman Dillon and Union Securities & Co. (Pltf. Ex. 39, II–A. 601–608). This proposal called for financing the new building through the issuance of collateral notes that would be sold to investors. The lease would be noncancelable for the first ten years and the rentals would be sufficient to repay the notes and interest and provide "a modest cash income" to the lessors (Pltf. Ex. 39, II–A. 603–605). Under this proposal, Worthen would have repurchase options, based on straightline depreciation over a forty-year useful life, as follows (Pltf. Ex. 39, II–A. 608):

Repurchase Option Date	*Difference: Repurchase Price Over Debt Balance*
15th year	133,835
20th year	1,108,781
25th year	2,887,500
30th year	1,925,000

To simplify the computation of the repurchase price, Stephens and Eastman Dillon suggested that it would be desirable for Worthen to continue to own the land underlying the building and parking deck (Pltf. Ex. 39, II–A. 602–603).

building (I–A. 149, 189; Pet. App. B 16a). At the same time, petitioner's majority shareholder and board chairman, Frank Lyon, who also served on Worthen's board of directors, learned of Worthen's proposed sale-and-leaseback transaction and entered the negotiations (I–A, 143–148, 254–255). On October 30, 1967, Lyon proposed that petitioner, his company, serve as the outside "investor" to hold title to the building under the sale-and-leaseback plan (Pltf. Ex. 11, II–A. 346–347). Lyon suggested annual rentals of $50,000 less than the mortgage payments on the building for the first ten years and an option for Worthen to repurchase the building after 15 years for $1,700,000 cash, plus the assumption of the unpaid mortgage balance (Pltf. Ex. 11, II–A. 346).

On October 31, 1967, after incorporating what it believed to be the "best part" of each proposal, Worthen made a counter-proposal to Goldman Sachs, Stephens, Inc. and petitioner (I–A. 143–144; Pltf. Ex. 12, II–A. 348; Pltf. Ex. 13, II–A. 349–351). Worthen's counter-proposal called for the investor to supply an "equity" of $500,000, which would bear "interest" compounded at the rate of six percent per year (Pltf. Ex. 13, II–A. 350; Pet. App. B 17a). Interim construction financing would be supplied by City Bank (I–A. 149; Pltf. Ex. 13, II–A. 349–350) and the permanent financing would be supplied by New York Life at 6¾ percent payable over 25 years.

Worthen proposed to bear all of the costs in maintaining the building under a "net" lease with the investor, with "rentals" to be paid by Worthen over

the 25-year initial term of the lease precisely equal to the amounts required to amortize the New York Life loan over the same period (Pet. App. A 5a). Worthen would retain ownership of the land and lease it to the investor for a nominal rent during the initial term of the building lease. Worthen would also have an option to repurchase the building at the end of the 11th, 15th, 20th and 25th years, with the option prices to be the sum of: (1) the assumption of the unpaid balance of the mortgage; and (2) the $500,000 advance made by the investor, with interest compounded at an annual rate of six percent (Pet. App. B 19a; I–A. 79–81; Pltf. Ex. 13, II–A. 350–351). On November 1, 1967, after petitioner accepted Worthen's counterproposal, Worthen selected petitioner to serve as the "investor."[8]

[8] As an additional inducement to Worthen, petitioner agreed to reduce Worthen's rent on the building by $21,000 per year below the mortgage payments for the first five years of the lease (I–A. 42, 71; Pltf. Ex. 14, II–A. 352; Pet. App. A 5a; Pet. App. B 17a–18a). But New York Life would not accept an assignment of a lease providing for a reduction in rent of $21,000 per year less than the principal and interest payments due on the mortgage. As a result, Worthen and petitioner entered into a lease at rentals precisely equal to the mortgage payments, as Worthen had originally proposed (I–A. 109–111; Pet. App. B 17a).

By separate agreement, however, petitioner agreed to provide for the $105,000 ($21,000×5) reduction in rent by paying Worthen an interest rate three percent greater than its usual borrowing rate from Worthen on a subsequent $500,000 loan from Worthen in August 1969. As of trial, Worthen had not required repayment of this one-year demand note (Pet. App. B 17a–18a n. 1). The testimony indicated that Worthen had treated this loan more favorably than other loans that Worthen has made to petitioner (I–A. 59–70).

B. THE TERMS OF THE SALE-AND-LEASEBACK ARRANGEMENT

In May 1968, petitioner, Worthen, City Bank, and New York Life executed a set of inter-locking agreements with respect to the sale-and-leaseback of the bank building whereby Worthen "sold" its building as it was constructed to petitioner and Worthen then "leased back" the building from petitioner (I–A. 29–30; Pet. App. B 18a).[9] The terms of these agreements can be summarized as follows.

1. *Agreements Between Petitioner and Worthen.*— Petitioner and Worthen executed a sales agreement, a ground lease, and a building lease. Pursuant to the sales agreement of May 19, 1968 (Pltf. Ex. 25, II–A. 508–522), Worthen sold to petitioner all of the mechanical, electrical and structural components (but not the interior) of the building as they were constructed, for a price not to exceed $7,640,000 in "reimbursements" for expenditures incurred by Worthen for the construction of the building (I–A. 45–46, 237–238; Pltf. Ex. 25, Sec. 2, II–A. 511–514).[10] Worthen

[9] In November 1967, subject to various guarantees, assignments, warranties and representations made by Worthen, City Bank and New York life agreed to the sale-and-leaseback arrangement between Worthen and petitioner under which they would respectively provide the interim construction financing and the permanent mortgage (Pltf. Exs. 16, 17, II–A. 356–362). In April 1968, Worthen obtained the approval of the Arkansas State Bank Department and the Federal Reserve Bank for the transaction (Pltf. Exs. 40–44; II–A. 609–622).

[10] Worthen determined the sales price by subtracting its allowable $4,000,000 capital investment in the project from the estimated total cost of the building (I–A. 44, 189; Pltf. Ex. 43, II–A. 620–621).

agreed to indemnify petitioner from all claims arising out of Worthen's failure to complete construction of the building by the closing date of December 1, 1969 (Pltf. Ex. 25, Secs. 3(j), 7, II–A. 516–517, 520).

Under the ground lease dated May 1, 1968, Worthen agreed to lease the underlying land to petitioner for 76 years and seven months. For the first 25 years, the ground rent was to be $50.[11] Thereafter, the annual ground rent payable by petitioner to Worthen would be sharply increased as follows (Pltf. Ex. 18, Sec. 3, II–A. 367–368):

12-1-1994 thru 11-30-1999 (5 years)	$100,000
12-1-1999 thru 11-30-2004 (5 years)	150,000
12-1-2004 thru 11-30-2009 (5 years)	200,000
12-1-2009 thru 11-30-2014 (5 years)	250,000
12-1-2014 thru 11-30-2034 (20 years)	250,000
12-1-2034 thru 11-30-2044 (10 years)	10,000

Under the building lease dated May 1, 1968 (Pltf. Ex. 19, II–A. 376–442), petitioner agreed to lease the building back to Worthen for a primary term of 25 years, with options for Worthen to extend the lease for eight additional five-year terms (Pltf. Ex. 19, Secs. 1, 2, 2.1 II–A. 377–378). Worthen was not obligated to pay rent until December 1, 1969, the date of expected completion of the building. From that date

[11] The testimony at trial was that the fair rental value of the underlying land in 1968 was $100,000 a year (I–A. 169, 249). However, Worthen agreed to charge petitioner a nominal ground rent during the initial 25-year term of the ground lease (when the New York Life mortgage was outstanding) because petitioner would have passed the cost of any higher ground rent back to Worthen in the form of an increased building rent (I–A. 169) (See also Pet. App. B 19a, n. 3).

until November 30, 1980, the lease provided that Worthen's annual rent would be $582,324; thereafter until November 30, 1994, the annual rent was $613,156 (Pltf. Ex. 19, Sec. 3.1, II–A. 378–379).

These rentals during the primary 25-year term were exactly equal to the principal and interest payments under the $7,140,000 New York Life mortgage that would amortize that loan over the same period (I–A. 76, Pet. App. A 5a; Pet. App. B 18a–19a; Deft. Ex. 7, II–A, 697–700). As required by New York Life (Pltf. Ex. 17, II–A. 364), the building rent was payable to petitioner or its assignee on an absolutely net basis without any deduction, counterclaim or setoff (I–A. 101; Pltf. Ex. 19, Secs. 3.2, 5.1, II–A. 379, 380–381; Pltf. Ex. 29, Sec. 5, II–A. 582).

During the eight five-year extended terms of the lease, when the New York Life loan would be paid off, the annual building rent was reduced to $300,000. However , this diminished rent was further decreased by petitioner's obligation to pay greatly increased ground rent to Worthen after 25 years.[12] Thus, while Worthen's net rent for the last year of the primary term was $613,154 ($613,156 minus $2 ground rent), its net rent for the first year of the extended term was reduced to $200,000 ($300,000 minus $100,000 ground rent). The rent was correspondingly reduced during the extended period so that during the last 25 years of the extended term, the net annual rent payable by

[12] The ground lease would terminate if Worthen did not renew the building lease or if it exercised its option to purchase the building (Pltf. Ex. 18, Sec. 9, II–A. 369).

Worthen was only $50,000 ($300,000 minus $250,000 ground rent (I–A. 168–170; Pet. App. B 19a n. 3).[13]

As a result, the net rent payable by Worthen during the primary term of the lease was approximately eight percent of the $7,640,000 cost of the building; however, the net rent during the extended terms ranged from 2.6 percent to 0.6 percent of the cost of the building. Finally, the net amounts payable over the extended terms of the lease approximated the amount required to repay petitioner's $500,000 investment at six percent compound interest (Pet. App. B 26a–27a).

The building lease was a net lease. Thus, Worthen bore all costs, risks and responsibilities for the building, such as repairs, maintenance, taxes, utilities and insurance (Pltf. Ex. 19, Secs. 7.1, 9.1, 12, 14, II–A. 382–389, 391–395; I–A. 99–105, 213–214).[14] Any condemnation award or insurance proceeds arising from the total destruction of the building were to be applied first to discharge the full amount of the New York

[13] Edward M. Penick, Worthen's president and a member of its new building finance committee, testified that the net building rentals payable by Worthen during the extended term were a "very, very cheap price" (I–A. 168). C. V. Barnes, petitioner's real estate appraiser, described the rental terms on the building after 1994 as being "favorable to the bank" (I–A. 251). Likewise, petitioner's board chairman, Frank Lyon, characterized these same rents as "low" (I–A. 261).

[14] Worthen further agreed to indemnify petitioner for any claims connected with the building, and agreed to repair any damage to the building and to pay rent notwithstanding any such damage (Pltf. Ex. 19, Secs. 11, 13, 17.1, 17.3, II–A. 385–386, 389–391, 404, 407–408).

Life mortgage, then to petitioner in accordance with a "Termination Table,"[15] and any remaining amount to Worthen (Pltf. Ex. 19, Secs. 17.6, 18.4, Table A, II–A. 408–410, 415–417, 439–442; Pet. App. B 20a–21a).

Finally, pursuant to the lease, petitioner gave Worthen an option to repurchase the building exercisable at stated intervals and prices as follows (Pltf. Ex. 19, Sec. 20.1, II–A. 419):

Option date	*Price*
November 30, 1980 (11th year)	$6,325,169.85
November 30, 1984 (15th year)	5,432,607.52
November 30, 1989 (20th year)	4,187,328.04
November 30, 1994 (25th year)	2,145,935.00

In accordance with Worthen's original specification for the sale-and-leaseback arrangement (Pltf. Ex. 13, II–A. 350), the repurchase option prices were the sum of: (1) the assumption of the unpaid balance of the New York Life mortgage, (2) a return of petitioner's $500,000 advance; and (3) six percent interest compounded on the $500,000 advance (I–A. 74–76, 249; Pet. App. B 19a).[16]

[15] The "termination table" set forth the repurchase option prices. As the court below noted, the table was geared to provide a return of petitioner's $500,000 investment at six percent interest compounded annually (Pet. App. B 20a; Pltf. Ex. 19, Table A, II–A. 439–442).

[16] The amounts payable by Worthen over and above the unpaid mortgage balance on the exercise of these options were as follows (Pltf. Exs. 13, 40, 41; II–A. 350, 611, 615):

Nov. 30, 1980	$800,000
Nov. 30, 1984	1,000,000
Nov. 30, 1989	1,603,568
Nov. 30, 1994	2,145,935

2. *Construction Financing Agreements.*—By agreement dated May 14, 1968, City Bank agreed to lend petitioner $7 million for the construction of the Worthen Building that had begun in September, 1967 (Pltf. Ex. 21, II–A. 462). The loan was secured by a mortgage on the building, pursuant to which both petitioner and Worthen conveyed title to the building, land, and parking facility to City Bank as security for the construction loan (Pltf. Ex. 23, II–A. 490–502). As additional security, petitioner assigned its interest in the building lease and ground lease (Pltf. Ex. 24, Sec. 2, II–A. 505). If City Bank's construction loan was not fully repaid by December 1, 1969, Worthen guaranteed that it and petitioner would enter into a new building lease that would provide for sufficient rentals to amortize the loan in a manner acceptable to City Bank (Pltf. Ex. 35, II–A. 592; Pet. App. B 18a, n. 2).[17]

By means of a separate letter agreement, Worthen also reserved the right to repurchase the building at a negotiated price in the event Frank Lyon, his immediate heirs or current working associates, proposed to sell their stock in petitioner to someone who was unacceptable to Worthen (I–A. 173–174; Pltf. Ex. 50, II–A. 686; Pet. App. B 21a n. 5). The negotiated repurchase price was related to Worthen's favorable option prices and low extended term rentals in the building lease (I–A. 250–251; Pet. App. B 26a).

[17] The disbursements of the interim construction funds from City Bank of New York were accomplished as follows: After receipt of an architect's certificate, an independent certified public accountant's opinion, and an affidavit from an officer of Worthen that certain work had been performed, petitioner would present these documents to City Bank for an advance on the $7,000,000 construction loan (I–A. 45–46; Pltf. Ex. 21, II–A. 465–467; Pltf.

3. *Permanent Financing Agreements.*—New York Life agreed to purchase a $7,140,000 6¾ percent secured note issued by petitioner upon the completion of the building on December 1, 1969 (Pltf. Exs. 20, 26, II–A. 443–461, 523–526). Under the note-purchase agreement, petitioner warranted that it would lease the building to Worthen for a non-cancelable term of at least 25 years under an absolutely net lease at a rent at least equal to the mortgage payment on the note (Pltf. Ex. 17, II–A. 360, 364; Pltf. Ex. 20, Sec. 4C, II–A. 449). Petitioner agreed to make annual payments of principal and interest of $582,324 for the first 11 years and $613,156 for the next 14 years (Pltf. Ex. 26, II–A. 523–526). These amounts were exactly equal to the rentals payable by Worthen during the corresponding 25-year primary term of the lease. See pp. 12–13, *supra*. To the extent that the rental payments exceeded the interest on the New York Life mortgage and amortized the loan, they reduced the option price on a dollar-for-dollar basis (Pet. App. B 26a).

Ex. 25, II–A. 511–514). Petitioner would then write a check for the amount of the advance received from City Bank of New York and deposit it for the credit of Worthen in an account of Worthen's or at another bank (I–A. 45, 55, 75; Pltf. Ex. 32, II–A. 584–586). When the building was completed on December 1, 1969, the $7 million construction financing loan from City Bank of New York was repaid from the proceeds of the permanent loan of $7,140,000 advanced on the same date by New York Life (I–A. 47). The remaining $500,000 in financing was supplied by petitioner (I–A. 217–218; Pltf. Ex. 13, II–A. 350). Worthen's actual cost of constructing the office building and parking complex (excluding the land) exceeded $10 million (Deft. Ex. 11, II–A. 701–704).

Although petitioner was designated as the formal borrower on the New York Life note, both petitioner and Worthen provided New York Life with security for the payment of the loan. Pursuant to the deed of trust, petitioner conveyed to New York Life title to the building and assigned all of its rights and interest in the building and ground leases to secure payment of the note (Pltf. Ex. 27, II–A. 528–529).[18] Worthen consented to petitioner's assignment of the building lease to New York Life and agreed to make all required payments to New York Life (Pltf. Ex. 29, II–A. 582; Pet. App. B 18a). Worthen also pledged the land, parking facility, and its ownership interest in the air space and certain easements in the building as additional security (Pltf. Ex. 27, II–A. 529).

C. THE PROCEEDINGS BELOW

On its income tax return for 1969, petitioner reported the payments Worthen made to it under the building lease as rental income, and claimed deductions for depreciation on the Worthen Building, mortgage interest paid on the interim and permanent loans, and other expenses in connection with the construction of the building. On audit, the Commissioner of Internal Revenue determined that petitioner was not the owner of the Worthen Building for federal tax purposes. The Commissioner determined that the sale-and-leaseback arrangement was a financing trans-

[18] As further security for the loan, petitioner assigned to New York Life its power to modify or terminate the building lease to Worthen (Pltf. Ex. 28, Sec. 5, II–A. 574).

action in which petitioner loaned Worthen $500,000 and acted as a conduit for the transmission of principal and interest from Worthen to New York Life. Accordingly, the Commissioner disallowed petitioner's claimed deductions for depreciation, interest, and other expenses, and excluded the rental income reported by petitioner from its gross income (Pltf. Ex. 52, II–A. 689; Pet. App. A 7a–8a; Pet. App. B 21a).[19]

In this refund suit brought by petitioner in the United States District Court for the Eastern District of Arkansas to recover the additional taxes it paid as a result of the Commissioner's assessment, the district court held that petitioner was entitled to be treated as the owner of the building for purposes of claiming deductions for mortgage interest and depreciation (Pet. App. A 1a–3a). In the district court's view, the intent of the parties, as expressed by the written instruments, was to accomplish a sale-and-leaseback of the building with an option to Worthen to repurchase it (Pet. App. A 1a–2a).

The court of appeals unanimously reversed (Pet. App. B 15a–30a). It held that the Commissioner correctly determined that petitioner was not the true owner of the building and therefore was not entitled to depreciation or mortgage interest deductions.

In support of its conclusion, the court cited, *inter alia*, the following facts: (1) The lease agreements

[19] Consistent with his determination against petitioner, the Commissioner allowed Worthen deductions for depreciation and mortgage interest, and disallowed Worthen's claimed deductions for rent (I–A. 219).

circumscribed petitioner's right to profit from its investment in the building by giving Worthen the option to purchase the building at stated intervals for $500,000 (the amount of petitioner's equity), plus six percent compounded interest, and to assume the unpaid balance of the New York Life mortgage; (2) the option prices did not take into account possible appreciation of the value of the building or inflation; (3) any award realized as a result of the destruction or condemnation of the building in excess of the mortgage balance and petitioner's $500,000 investment would be paid to Worthen and not petitioner; (4) the building rental payments during the 25-year primary term were exactly equal to the mortgage payments so that petitioner merely served as a conduit by which the mortgage payments would be transmitted to New York Life; (5) Worthen retained control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the underlying land; and (6) Worthen enjoyed all benefits and bore all burdens incident to the operation and ownership of the building so that the only economic advantage accruing to petitioner, in the event it were considered to be the true owner of the property, were income tax savings of $1.5 million during the first 11 years of the arrangement (Pet. App. B 25a–28a).

In light of these facts, the court concluded that (Pet. App. B 28a) "[t]he overall nature of this transaction is closely akin to that in *Helvering* v. *F. & R. Lazarus & Co.* [308 U.S. 252]" where this Court held that under an essentially-identical arrangement, the purported seller-lessee was the true owner of property for federal tax purposes. In accordance with the rule established in *F. & R. Lazarus Co.*, the court of appeals therefore held that "the benefits, risks, and burdens which * * * [petitioner] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes" (Pet. App. B 29a).[20]

SUMMARY OF ARGUMENT

I

1. The court of appeals correctly held that under this Court's decision in *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252, the sale-and-leaseback transaction at issue in this case did not confer upon petitioner any significant ownership interest in the building that would entitle petitioner to income tax deductions for mortgage interest and depreciation. In *Lazarus*, this Court unanimously held that the taxpayer could disregard the form of a sale-and-leaseback transaction where the economic benefits and burdens of ownership were retained by the purported seller-lessee, whose payment of "rentals" simply served to amortize the mortgage loan on the property. Thus, the Court permitted the seller-lessee to claim depreciation deduc-

[20] On petitioner's petition for rehearing, the court of appeals modified its opinion to provide for a remand to the district court for further findings with respect to petitioner's claimed deductions for interest on the interim construction loan and for miscellaneous additional expenses in connection with these agreements (Pet. App. D 32a–33a).

tion on real property nominally titled in the lessor. Here, in a transaction that the court of appeals recognized to be "closely akin" (Pet. App. B 28a) to that in *Lazarus,* the decision below properly permitted the Commissioner likewise to disregard the form in favor of the economic substance of the arrangement and to disallow petitioner's claimed interest and depreciation deductions.

As in *Lazarus,* the nominal seller of the property (the Worthen Bank) remained in possession of the premises and paid rentals calculated to provide a fixed return on the purported purchaser's investment. The "rental" payments made by Worthen exactly equaled petitioner's principal and interest payments on the New York Life mortgage (Pet. App. B 18a–19a). Moreover, Worthen had an absolute obligation to make the rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding (Pet. App. B 18a). Moreover, it was impossible for Worthen toterminate the arrangement because it expressly consented to the assignment of petitioner's iterestin the lease as security for the loan.

Thus, Worthen's role in the transaction was identical to that of a mortgage debtor who has an absolute obligation to make payments to the mortgage lender over the life of the mortgage. In substance, Worthen mortgaged the building; petitioner's role was at best that of a conduit to forward Worthen's mortgage payments, cast in the form of "rentals," to the mortgagee, New York Life. Indeed, Worthen agreed to transmit

the "rent" directly to the mortgagee without even involving petitioner. Under these circumstances, petitioner is not entitled to deductions for mortgage interest and depreciation because it had no ownership interest or investment in the property.

Moreover, the repurchase options retained by Worthen further demonstrate that petitioner did not bear any of the benefits and burdens of ownership. Here, as in *Lazarus,* the purported seller-lessee (Worthen) had the option to repurchase the property for an amount equal to the unpaid mortgage balance and petitioner's investment, plus interest (see Pet. App. B 19a). At stated intervals during the term of the agreement, Worthen could have stepped into the shoes of petitioner and acquired title to the building simply by assuming the mortgage and repaying petitioner's $500,000 investment plus interest. Since petitioner did not stand to benefit from any appreciation in the value of the building or stand to suffer any loss from any decrease in its value (unless the value fell below the option price), it did not own the building in any realistic sense of the word.

2. Petitioner seeks to minimize the significance of the option to repurchase by citing the district court's finding (Pet. App. A 6a) that it was unlikely that Worthen would exercise the option. But as the court of appeals correctly recognized (Pet. App. B 19a), the reason why Worthen might not exercise its option to repurchase at the end of the primary term, if not before, is that it had the right to occupy the building

for an additional 40 years, retaining all of the benefits of ownership, at drastically reduced rentals, which Worthen's president conceded were a "very, very cheap price" (I–A. 168). These bargain rentals would repay petitioner its $500,000 investment with a return of slightly less than six percent compounded interest. Moreover, since Worthen retained title to the underlying land, it was assured, in any event, of recovering absolute possession and ownership of the property on the expiration of the ground lease a relatively short time after the end of the extended term of the building lease. The district court's finding with respect to the likelihood of Worthen's exercise of the option and the reasonableness of the rents during the *primary* term are therefore irrelevant.

Petitioner's ready acceptance of an arrangement in which it had no significant prerogatives of ownership can only be explained in terms of the benefit of the substantial depreciation deductions it would receive if the tax consequences followed the form of the arrangement. Worthen's dictation of all the terms of the transaction and petitioner's willingness to reduce the building rent below the amount proposed by Worthen belies petitioner's characterization of the arrangement as the product of "hard, arms-length bargaining."

If, as the court of appeals noted (Pet. App. B 24a), the various obligations and rights of ownership are analogized to a "bundle of sticks," it is clear that Worthen held most, if not all, of the "sticks" and petitioner few or none. Since it is virtually inconceivable that Worthen would simply walk away from its

investment in this building at the end of 25 years after it had fully paid for its construction (except for the return of petitioner's $500,000 investment), the only risk borne by petitioner was that Worthen would become insolvent. But that is nothing more than the risk which would be borne by the guarantor of a loan rather than the owner of real property. The court of appeals therefore correctly held that Worthen, and not petitioner, was the actual owner of the building. Accordingly, Worthen and not petitioner is entitled to claim deductions for mortgage interest and depreciation with respect to the building.

II

The court of appeals correctly held that the ultimate characterization of a sale-and-leaseback arrangement for tax purposes is a question of law that is freely reviewable on appeal. While results may differ in accordance with the details of a given transaction, the arrangements in these cases are spelled out in undisputed written documents that call for legal interpretation under the economic substance standard of *Lazarus*. Testimonial evidence concerning the "intent" of the parties is accordingly irrelevant.

The court of appeals therefore properly disregarded the district court's finding that the parties subjectively intended a true sale. In this respect, its decision is in accord with the decisions of other courts of appeals that have held that the question whether such agreements are true sales or financing transactions is one of law. *American Realty Trust* v.

United States, 498 F. 2d 1194, 1198 (C.A. 4); *Estate of Franklin* v. *Commissioner,* 544 F. 2d 1045, 1047 n. 3 (C.A. 9); *American National Bank of Austin* v. *United States,* 421 F. 2d 442, 451 (C.A. 5), certiorari denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States,* 426 F. 2d 115, 117–118 (C.A. 6), certiorari denied, 400 U.S. 827; *Oesterreich* v. *Commissioner,* 226 F. 2d 798, 801–802 (C.A. 9).

ARGUMENT

I

THE SALE AND LEASEBACK ARRANGEMENT IN THIS CASE WAS A FINANCING TRANSACTION UNDER WHICH PETITIONER DID NOT HAVE ANY SIGNIFICANT OWNERSHIP INTEREST OR INVESTMENT IN THE BUILDING THAT WOULD ENTITLE IT TO TAX DEDUCTIONS FOR MORTGAGE INTEREST AND DEPRECIATION

A. THE ECONOMIC SUBSTANCE OF SALE AND LEASEBACKS IS CONTROLLING FOR FEDERAL TAX PURPOSES

1. This case involves an application of the well-settled principle announced by this Court almost 50 years ago that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss* v. *Bowers,* 281 U.S. 376, 378. In numerous cases, the Court has refused to permit the transfer of legal title to property to shift the incidents of taxation attributable to the ownership of the property where the transferor retains significant control

over the property transferred. See, *e.g., Commissioner* v. *Sunnen,* 333 U.S. 591; *Helvering* v. *Clifford,* 309 U.S. 331.

In applying this principle, commonly referred to in the literature as the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than the particular form in which the parties organized the transaction. The parties to such arrangements generally select forms designed to achieve particular tax consequences. Thus, for example, if they seek to have their arrangement treated as a sale, the parties will use the words "sale" and "sales agreement;" if they wish certain payments to be characterized as "rent," they will execute a "lease."

But the Court has never regarded "the simple expedient of drawing up papers" (*Commissioner* v. *Tower,* 327 U.S. 280, 291) as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering* v. *F. & R. Lazarus & Co.,* 308 U.S. 252, 255. See also *Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260, 266–267; *Commissioner* v. *Court Holding Co.,* 324 U.S. 331, 334. Nor is the parties' desire to achieve a particular tax result relevant. As the Court stated in *Commissioner* v. *Duberstein,* 363 U.S. 278, 286, "[i]t scarcely needs adding that the parties' expectations or hopes as to the tax treatment

of their conduct in themselves have nothing to do with the matter."

2. While the transaction in this case is complicated by an elaborate set of legal arrangements, its essential elements can be illustrated by the following two examples. Suppose A owns a building that is worth $100,000 and wishes to sell it to B at that price. B does not have the entire $100,000, but offers to put up $20,000 and obtain a mortgage from an outside lender for the $80,000 difference. The transaction is concluded on that basis and B takes title to the buildings, subject to the mortgage, to do with it as he sees fit—either to rent it to a tenant of his choice, to sell it, to occupy it himself, or simply to hold it in the hope that the building or the underlying land will appreciate in value.

In such a case, no one would doubt that there has been a "sale" and that B "owns" the building for tax purposes as well as for any other purpose. "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent," *Iowa* v. *McFarland,* 110 U.S. 471, 478; it is a contract "to pass rights of property for money—which the buyer pays or promises to pay to the seller * * *." *Williamson* v. *Berry,* 8 How. 495, 544. In the parlance of real estate, B enjoys the "benefits" and bears the "burdens" of ownership because he will realize any appreciation or suffer any decrease in the value of the property.

But suppose the following variation on the foregoing example. A enters into a "sales agreement" to

sell the building to B for $100,000 and B puts up $20,000 and agrees to obtain an $80,000 mortgage. B thereafter leases the building back to A for a term equal to the term of the mortgage and for a net rental exactly equal to the mortgage payments. Moreover, B gives A an option to reacquire the building during the term of the lease for a price equal to the unpaid mortgage balance and the $20,000 plus interest. After the lease expires and the mortgage is paid off, A has an option to reacquire the building for B's investment of $20,000 plus interest.

After the expiration of the lease and the satisfaction of the mortgage, B is theoretically free to dispose of the building as he sees fit just as in the first example. But B's theoretical ownership at that point in time must be viewed in the context of A's option to reacquire the property. A, of course, may not exercise the option. However, if the $20,000 option price is below the fair market value of the building, it is highly unlikely that A will not exercise the option. Since A has in effect "paid off' the mortgage through his rentals, the relatively nominal option price, as compared with the original cost of the building, makes a compelling economic case for the exercise of A's right of reacquisition.

The likelihood that A will step into B's shoes at the termination of the arrangement therefore is incompatible with the conclusion that B "owns" the building. Indeed, B can hardly be said to "own" the building because there is no realistic way that he can benefit from any appreciation of the property or suffer any

detriment from its decrease in value unless the value of the building falls below $20,000 plus the interest factor. Like any lender, B can only expect to receive his original $20,000 plus interest at a fixed rate.

Thus, the net effect of the transaction is nothing more than a loan of $20,000 by B to A that will earn a fixed rate of interest.

3. Stripped to its essentials, the Worthen Bank and petitioner respectively stand in the place of A and B in the second example. Here, like B, petitioner put up $500,000 and purported to purchase a building from the Worthen Bank and lease it back to Worthen for a 25-year primary term equal to the duration of the mortgage and for a "rent" exactly equal to B's mortgage payments. But while the arrangement was cast in the form of a sale and leaseback, the fact that in substance it was only a financing transaction is demonstrated by the terms of the repurchase options and lease renewals.

At stated intervals during the primary term, Worthen could reacquire the building simply by satisfying the mortgage debt and paying petitioner its $500,000 advance plus interest compounded at six percent, regardless of the fair market value of the building at the time Worthen exercised the option. Similarly, when the mortgage was paid off, Worthen could extend the lease at drastically reduced bargain rentals that likewise bore no relation to the fair rental value but were simply calculated to pay petitioner its $500,000 plus six percent compounded interest over the

extended term. Thus, petitioner's return on the arrangement could in no event exceed six percent compound interest. Moreover, the favorable option and lease renewal terms made it highly unlikely that Worthen would abandon the building after it in effect had "paid off" the mortgage.

4. Given the limited financial return from such a long-term arrangement, the question naturally arises why petitioner would enter into such an elaborate sale-and-leaseback transaction when it could have loaned the Worthen Bank $500,000 at six percent compound interest in a simple and straightforward manner. The answer lies in the tax laws, which permit a deduction for business rent (Section 162(a) of the Code), mortgage interest (Section 163) and depreciation (Section 167). If the parties could convince the tax collector to accept the form of the arrangement under which petitioner "owned" the building and Worthen "leased" it, Worthen could deduct the entire amount of its payments to petitioner as "rent," despite the fact that petitioner in reality was no more than a conduit who transmitted them on to the mortgage lender. Moreover, petitioner could in turn claim depreciation deductions (based on the cost of construction ultimately borne by Worthen) which it could offset against its other income, and deduct mortgage interest which would roughly offset the inclusion in its income of Worthen's rental payments.

But, if, as we submit and as the court of appeals held, the arrangement was a financing transaction un-

der which Worthen was the owner of the building, Worthen's payments would only be deductible to the extent that they represented mortgage interest and Worthen would be entitled to claim depreciation deductions with respect to the building. On the other hand, petitioner would not be entitled to deductions for either mortgage interest or depreciation. Moreover, petitioner need not include Worthen's "rent" payments in its income because its function with respect to those payments was that of a conduit between Worthen and the mortgagee.

B. *HELVERING* V. *F. & R. LAZARUS & CO.*, 308 U.S. 252, CONTROLS THIS CASE

1. The foregoing analysis is supported by this Court's decision in *Helvering* v. *F. & R. Lazarus & Co., supra,* the seminal precedent that controls this case. There, the Court considered the tax consequences of an essentially equivalent sale-and-leaseback arrangement and held that it was in reality a loan on the security of the property.

In *Lazarus,* the taxpayer, a department store, purported to sell its business property for cash to a bank, which was acting on behalf of the holders of certain land trust certificates. The bank simultaneously leased the property back to the taxpayer for 99 years. It also gave the taxpayer a right to renew the lease for a similar term. The rent was based upon an annual return of five percent on the cash advanced by the bank and was less than a fair rental for the property. In addition to the rent, the taxpayer was further obliged

to make periodic payments to a "depreciation fund" until the fund, with accumulated interest, equaled the cash put up by the bank.

Finally, the bank gave the taxpayer an option to reacquire the property at the call prices of the trust certificates, the aggregate of which were far below the fair market value of the property. Upon the taxpayer's exercise of the option, the amounts it paid into the depreciation fund would be credited against the option price. In the event the taxpayer did not exercise the option, the depreciation fund would become the property of the certificate holders.[21]

This Court unanimously upheld the Board of Tax Appeals' conclusion that the taxpayer's transfer of title to the bank was in reality a mortgage so that the taxpayer could continue to claim depreciation deductions with respect to the property. In the Board's analysis, the nominal rent stipulated in the lease-back showed that the "rent" was nothing more than interest payable on the bank's loan to the taxpayer. In this respect, the "depreciation fund" to which the taxpayer was required to make payments was the mechanism for amortizing the loan. Finally, the minimal option prices and the dollar-for-dollar reduction of those prices by the taxpayer's amortization payments demonstrated that the taxpayer's exercise of the option was virtually inevitable. For whether or not the taxpayer exercised the option, the amortization pay-

[21] The facts are set forth in detail in the opinion of the Board of Tax Appeals (*F. and R. Lazarus & Co.* v. *Commissioner*, 32 B.T.A. 633).

ments belonged to the bank. Thus, the option price was the difference between the call price of the trust certificates and the amortization fund. Since the taxpayer was in all events required to make all of the amortization payments to the fund, it would have been highly unlikely that it would have forfeited its right to reacquire the property for failure to pay the nominal additional amount prescribed under the arrangement.

Under these circumstances, this Court agreed that "the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease-back, was actually a loan secured by the property involved" (308 U.S. at 255). As the Court observed, "General recognition has been given the 'established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money' [footnote omitted]" (*ibid.*). In so holding, the Court rejected the contention that the statutory right to depreciation follows legal title.[22]

2. The facts of the sale-and-leaseback arrangement at issue in this case confirm the correctness of the court of appeals' conclusion that the transaction was "closely akin to that in *Helvering* v. *F. & R. Lazarus & Co.*, * * *" (Pet. App. B 28a). Here, as in *Lazarus*, the nominal seller of the property (Worthen Bank)

[22] The District of Columbia Circuit had ruled that depreciation deductions could only be claimed by the title holder. *City National Bank Building Co.* v. *Helvering*, 98 F. 2d 216, 217 (C.A.D.C.).

remained in possession of the premises and paid rentals calculated to provide a fixed return on the purported purchaser's (petitioner's) investment. During the primary term of the lease, the "rental payments" made by Worthen exactly equaled petitioner's principal and interest payments on the New York Life mortgage (Pet. App. B 19a). Worthen had an absolute obligation to make the rental payments without any right of set-off or counterclaim, even if the building were destroyed (Pltf Ex. 19, Secs. 3.2, 5.1, II–A. 379–381; Ptlf. Ex. 29, Sec. 5, II–A. 582). It further agreed that it would not cancel the lease as long as the mortgage was outstanding (Pet. App. B 18a).

Moreover, Worthen could not terminate the arrangement because it expressly consented to the assignment of petitioner's interest in the lease as security for the New York Life loan (Pltf. Ex. 29, Sec. 5, II–A. 582). As additional security for the loan, petitioner assigned to New York Life its power to modify or terminate the building lease to Worthen. The parties were therefore locked into the arrangement at least for the primary term of the lease, in order to guarantee the payment of the New York Life loan.

Accordingly, Worthen's role in the transaction was identical to a mortgage debtor who has an absolute obligation to make payments to the mortgage lender over the life of the mortgage. In substance, Worthen mortgaged the building; petitioner's role in the transaction was nothing more than a conduit through which Worthen's mortgage payments, cast in the form of "rentals," were forwarded to New York Life.

Indeed, in consenting to the assignment of the building lease, Worthen agreed that payment of the rent would "be made directly to * * * [New York Life] so long as the Assignment shall continue in force * * *" (Pltf. Ex. 29, Sec. J, II–A. 582). This provision suggests that petitioner was not even a conduit but simply a nominal title holder. But as the Fifth Circuit admonished in *Holbrook* v. *Commissioner*, 450 F. 2d 134, 141, "The mere transfer of bare legal title to property is not enough to constitute a 'sale' for income tax purposes if the transferor continues to exercise virtually all his former control, and stands in the same economic position as he did prior to the transfer. See Helvering v. Clifford, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788 (1940); Helvering v. F. & R. Lazarus and Co., 308 U.S. 252, 60 S. Ct. 209, 84 L. Ed. 226 (1939); Shaw Construction Co v. Commissioner of Internal Revenue, 9th Cir. 1963, 323 F. 2d 316."

Here, it cannot be denied that Worthen "continues to exercise all * * * [its] former control and stands in the same economic position as * * * [it] did prior to the transfer" of legal title to petitioner. As we have pointed out, Worthen's payments during the primary term of the lease were exactly equal to the amounts due under the New York Life mortgage. Moreover, the leaseback arrangement imposed virtually all risks, expenses, and obligations of ownership on Worthen. Thus, not only was Worthen responsible for repairs, maintenance, property taxes, insurance and operating expenses, but it was also required to hold petitioner harmless on all claims arising from the building, and

to comply, at its own expense, with all governmental regulations with respect to the building (I–A. 99–105, 213–214; Pltf. Ex. 19, II–A, 38–395, 404, 407–408). Under these circumstances, petitioner would neither receive nor expend any funds whatsoever in connection with its "ownership" of the building during the first 25 years of the arrangement.

To be sure, there are so-called "net" leases which require the tenant to bear all of the expenses of the property. Furthermore, a property may be so heavily mortgaged that its fair rental value could not exceed the principal and interest payable under the mortgage. Thus, these two facts, standing alone, would not require the conclusion that a sale and leaseback was a financing transaction. The court of appeals acknowledged as much in stating that "many of the features of the lease in this case have been held not to terminate tax ownership when viewed independently" (Pet. App. B 30a). But the court correctly observed (*ibid.*) that "[t]he vice of the present lease is that all of these features have been employed in the same transaction with the cumulative effect of depriving * * * [petitioner] of any significant ownership interest."

Lazarus teaches that the critical element in determining whether these arrangements are true sales or financing transactions is the option to repurchase. If, as in this case, the purported lessee has an option to repurchase the property at an amount that is significantly less than its fair market value, then the necessary inference is that the "rent" paid is not for the use of the property but is the amortization mechanism

for a loan on the security of the property.[23] For while the lessee may decline to exercise the option, the low exercise price makes it highly improbable that he will fail to do so, especially after amortizing the loan over the term of the "lease."

Here, as in *Lazarus,* Worthen had the option, at various times during and at the end of the 25-year term, to reacquire the property at prices that bore no relation to its fair market value unencumbered by the bargain terms of the lease renewal periods (see pp. 44–48, *infra*). Under the option, Worthen could repurchase the building by paying or assuming the unpaid balance of the mortgage and repaying petitioner's $500,000 plus interest. As a result, each payment of "rent," to the extent it was allocable to amortization of the mortgage, reduced the option price on a dollar-for dollar basis. Thus, like any mortgagor, Worthen did not permanently relinquish its ownership of the building but could recover it at any time by paying or assuming the principal balance of the mortgage and the additional $500,000 of financing provided by petitioner. And like any mortgagee, petitioner could expect no more from the transaction than to recover its $500,-000 advance, plus interest.[24]

Moreover, the rentals over the extended term of the lease likewise demonstrate that the arrangement was

[23] The deduction for business rent is limited to property "to which the taxpayer has not taken or is not taking title or in which he has no equity." Section 162(a)(3) of the Code.

[24] At the end of the primary term, the final option price was $2,145,935, which was equal to petitioner's $500,000 plus interest compounded at six percent for 25 years (Pltf. Ex. 13, II–A. 350).

a financing transaction and not a sale. During the 25th year of the lease, when the New York Life mortgage was still outstanding, the net rentals payable by Worthen were $613,154 ($613,156 less $2 ground rent payable to Worthen). But if Worthen extended the lease, its net rent for each of the next five years was reduced by more than two-thirds to $200,000 ($300,-000 less $100,000 ground rent). During the two succeeding five-year terms, the net rent was $150,000 and $100,000, respectively. Finally, during the next 25 years of the extended term, the annual net rent was even further reduced to $50,000.

Petitioner made no showing that these reductions in rent were geared to the projected fair rental value of the property. Indeed, the testimony was precisely to the contrary. Worthen's president characterized the extended term rentals as a "very, very cheap price" (I–A. 168). Petitioner's president, Frank Lyon, acknowledged that these rents were "low" (I–A. 261) and its real estate appraiser agreed that they were "favorable to the bank" (I–A. 251). Thus, even if Worthen did not exercise the option to repurchase, the bargain rentals during the extended 40-year term would permit it to deprive petitioner of its right to a fair payment for the use and occupancy of his property.

Under these circumstances, petitioner cannot be deemed to "own" the property when its rights in it are so severely diminished.[25] Moreover, the rents dur-

[25] In support of its contention that it, rather than Worthen, owns the building, petitioner argues (Br. 40–41) that it will be

ing the extended term were calculated to permit Worthen to repay petitioner's $500,000 investment plus interest. As the court of appeals correctly noted, at the time of the expiration of the primary term, "the present value of the future net rentals for the next 40 years, discounted at six percent, would approximate * * * [petitioner's] original half-million dollar investment plus the compounded interest accrued to that date" (Pet. App. B 26a).[26]

In sum, whether Worthen exercised the option to repurchase or to renew the lease, petitioner would

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free to deal with the building at a reduced ground rent during the last ten years of the ground lease when the extended building lease will have expired. But such hypothetical rights that may arise after 65 years in the year 2034 are hardly relevant in determining which party is entitled to depreciation and mortgage interest deductions during the first 25 years of the arrangement. While petitioner speculates that it will receive $2.9 million during this final ten-year period (Br. 40), its own expert witness testified that after 25 or 30 years many such buildings would be functionally obsolete (I–A. 241). Likewise, the *amicus curiae* National Realty Committee agrees that (Br. 9–10) "it is highly probable that the economic life of the building will be exhausted during the ground lease term."

[26] While the final option price was $2,145,935, C. V. Barnes, petitioner's real estate appraiser, testified that the present value of the rentals over the 40-year extended term, discounted at six percent, would be less than that figure (I–A. 251). The computation yields $1,816,550. See C.R.C., *Standard Mathematical Tables, Interest Tables—Present Value of Annuity*; American Institute of Real Estate Appraisers, *The Appraisal of Real Estate*, pp. 427–467 (6th ed.). But as the court of appeals noted (Pet. App. B 27a), petitioner would have the opportunity to make up the difference during the final ten years of the ground lease. During that period, the ground rent was reduced to $10,000 per year and petitioner could negotiate a new rental with Worthen or another tenant.

receive no more and no less than its original $500,000 plus a fixed rate of interest. Under these circumstances, petitioner had no economic stake in the building, because it had "no return related to ownership risk" (Pet. App. B 28a); it simply loaned $500,000 to Worthen, to be repaid after 25 or 65 years, at Worthen's election.

Finally, the provisions of the lease relating to condemnation or destruction of the property were likewise geared to petitioner's $500,000 investment. In those events, New York Life would first be paid the mortgage balance, petitioner's recovery would be limited to its $500,000 advance plus six percent interest, and Worthen would receive the excess (Pltf. Ex. 19, II-A. 408-417). Thus, there was no possibility that petitioner would ever benefit from any appreciation in the value of the building. As the court of appeals correctly concluded, "the benefits, risks, and burdens which * * * [petitioner] has incurred with respect to the building are simply too insubstantial to establish a claim to the status of owner for tax purposes" (Pet. App. B 29a).[27]

3. The decisions of the lower courts support the foregoing analysis. In determining whether the sale-and-leaseback arrangements are true sales or financing

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[27] Since Worthen retained title to the underlying land, it was assured, in any event, of recovering absolute possession of the property on the expiration of the ground lease ten years after the end of the extended term of the building lease. In this respect, the law of Arkansas is in accord with the general common law rule that, unless the parties agree otherwise, improvements to real estate made by the lessee return to the owner of the land on the

transactions, the courts have emphasized the relationship of the lessee's option to repurchase to the property's fair market value, as well as the other factors present in this case. As the court put it in *Commissioner* v. *H. F. Neighbors R. Co.*, 81 F. 2d 173, 175 C.A. 6), a pre-*Lazarus* decision, "The more common criteria which indicate a borrowing and lending rather than purchase and sale, are inadequacy of consideration, provisions for redemption or reconveyance, continued possession and management of the property by the transferer, payment by him of taxes and assessments, and his receipt and use of the rents and prof-

expiration of the lease. See *Williams* v. *Kirby School Dist. No. 32*, 207 Ark. 458, 181 S.W. 2d 488, 490. While the parties may express a different understanding, they did not do so here.

Petitioner attempts to fill the gap by arguing (Br. 42) that "there is no equitable reason" why the common law rule should apply because Worthen "sold" the building to petitioner. But this contention assumes the very question in the case, *i.e.*, whether the arrangement was a sale or a financing transaction. Indeed, given the understanding of the parties that petitioner's return would be limited to six percent on its $500,000 and Worthen's amortization of the mortgage (Pltf. Ex. 13, II–A. 349–351), the "equities" strongly favor Worthen's absolute recovery of the building at the expiration of the ground lease. Thus, *Stirman* v. *Cravens*, 33 Ark. 376 (Sup. Ct.), upon which petitioner relies (Br. 42–43), is distinguishable. The "somewhat anomalous" (*id.* at 384) facts that prompted the court in that case to make an equitable division of the sales proceeds of property between land and improvements are absent here. The court of appeals therefore correctly characterized petitioner's claim to some form of equitable adjustment 75 years in the future as "dubious" (Pet. App. B 27a n. 6). At all events, it is hard to see how such a claim is relevant in considering whether petitioner is entitled to depreciation and mortgage interest deductions during the first 25 years of the arrangement.

its of the property." Accord: *Leeds and Lippincott Co.* v. *United States,* 276 F. 2d 927 (C.A. 3), affirming an unreported decision of September 1, 1959 (D. N.J.);[28] *Starr's Estate* v. *Commissioner,* 274 F. 2d 294 (C.A. 9); *Oesterreich* v. *Commissioner,* 226 F. 2d 798, 802–803 (C.A. 9); *Breece Veneer & Panel Co.* v. *Commissioner,* 232 F. 2d 319, 322–323 (C.A. 7); *American Realty Trust* v. *United States,* 498 F. 2d 1194, 1199 (C.A. 4); *Frito-Lay, Inc.* v. *United States,* 209 F. Supp. 886 (N.D. Ga.); *Frenzel* v. *Commissioner,* 1963 P–H Memo TC par. 63,276, decided October 7, 1963. See also *Estate of Franklin* v. *Commissioner,* 544 F. 2d 1045 (C.A. 9).

The commentators likewise agree that where the option price is not geared to the fair market value of the property the lessee in a sale and leaseback arrangement is considered to be the owner for tax purposes. Thus, in discussing the tax consequences of a sale and leaseback, Professor William L. Cary has written that where the option to repurchase is at a nominal price, "[t]he obvious danger lurking in such an option is that the sale will not be treated [by the Commissioner] as such but rather that the whole transaction will in effect be regarded as a loan." Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations,* 62 Harv. L. Rev. 1, 23 (1948).

[28] We are lodging with the Court ten copies of the district court's unreported decision in *Leeds and Lippincott Co.*, and are serving it upon counsel for the petitioner.

Similarly, in a more recent appraisal that focuses on this case and concludes that it was correctly decided, the authors reaffirm that the option to purchase "appears to have been the basis for most decisions." Rosenberg and Weinstein, *Sale-leasebacks: An analysis of these transactions after the* Lyon *decision,* 45 Journal of Taxation 146, 150 (September 1976). In describing the case law, they state that "Where the option price was relatively substantial in the context of the case, ownership by the lessor was sustained. Where the option price was nominal, the lessee has been considered the owner for tax purposes (footnotes omitted) (*id.* at 150)." In their view, "[t]his result is consistent with the realities of the business bargain" (*ibid.*). Finally, in describing the decision in this case, the authors conclude that "where a fixed price, as in *Frank Lyon Company,* is designed merely to provide the lessor with a predetermined fixed return, the substantive bargain is more akin to the relationship between a debtor and creditor than between a lessor and lessee" (*id.* at 149).

C. THE BARGAIN TERMS OF THE LEASE RENEWAL ARRANGEMENT DEMONSTRATE THAT IT IS A FINANCING TRANSACTION AND NOT A TRUE SALE

1. Petitioner does not claim "to controvert the long established principle of tax law that substance is to prevail over form" (Br. 49). Moreover, it does not dispute the relevance of the fact that an option price is less than the fair market value of the property in these sale-and-leaseback arrangements. To the contrary, petitioner acknowledges that in such transac-

tions (Br. 19–20) "[t]he option prices may be so low that it is inevitable that the option will be exercised and obvious that the parties intended that it would be * * *." However, it argues (Br. 28) that "the option prices and rentals were reasonable estimates of market values * * * and the district court found that they were the reasonable estimates of market price * * *." In support of this characterization, petitioner cites the testimony of C. V. Barnes, a Little Rock realtor.

But there is nothing in the record to support the district court's conclusion that the option purchase prices were reasonably geared to fair market value. Worthen's president acknowledged that, apart from the fact that Worthen had such favorable extension privileges under the lease, the building "would be a good buy" (I–A. 11) at the $2.1 million option price at the end of the primary term. Moreover, Barnes explained that his testimony that the option price was a reasonable attempt to approximate fair market value (I–A. 241) was based on the sharply reduced rental income that the building would yield during the extended terms of the lease (I–A. 251). As the court of appeals correctly observed (Pet. App. B 26a), "The parties took no account of likely appreciation in the value of the building nor inflationary factors, the latter an almost constant factor in economics for the past 40 years, nor otherwise provided for purchase at a future appraised valuation of the building."

Moreover petitioner chooses to focus only upon Barnes' testimony with respect to the rentals during the primary 25-year term (I–A. 236, 240). It is, however, the extended term rentals that are crucial to this case because they are, in the context of this transaction, the functional equivalent of an unreasonable option-to-purchase price. With respect to the extended term rentals, Barnes conceded that they were "favorable to the bank" (I–A. 251) and Worthen's president described them as a "very, very cheap price" (I–A. 168).

"Figures speak and when they do, Courts listen." *United States* v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808, 809 (C.A. 5) (Brown, *J.*, concurring). Here, the figures eloquently confirm the witnesses' uniform characterization of the renewal rentals. While Worthen was obligated to pay approximately $600,000 per year in building rent during the primary term 1968–1994), the extended term net rentals were cut to $200,000 per year for the first five years, $150,000 for the second five-year term, $100,000 for the third five-year term, and $50,000 per year for the next 25 years until the year 2035.[29]

Because of these reduced rents, there would be no need for Worthen to exercise its repurchase option in

[29] The reductions in rent during the extended term were accomplished by increases in the ground rent payable by petitioner to Worthen. While the ground rent was $50 for the initial 25-year term, it increased to $100,000 per year for the first five-year extended term, and in $50,000 increments for the next two five-year terms, and to $250,000 for the next 25 years. See p. 12, *supra*.

1994 for $2.1 million, since it could have continued to control the building at a "very, very cheap price" without reacquiring title to it. The testimony cited by petitioner that Worthen was unlikely to exercise its repurchase option (Br. 20–21 nn. 12, 13) is therefore irrelevant because that testimony was given in the context of the axailability of the favorable option to renew the lease.[30] As Barnes testified, "I don't think in 1994 it would be economic for Worthen Bank to exercise the option to purchase, *because* I think the rental terms on the building thereafter are favorable to the bank" (I–A. 251) (emphasis supplied). Put another way, when faced with the alternatives of paying $2.1 million in 1994 to repurchase the property or $1.8 mil-

[30] In computing the deficiency in petitioner's tax liability for 1969, the revenue agent assumed that Worthen would exercise its option to repurchase the building at the end of the 11th year, when petitioner would cease to have any net tax deductions from the arrangement (see Pltf. Ex. 36, II–A. 595). Accordingly, the agent included in petitioner's 1969 income the amount of interest ($2,298.15) allocable to the one month in that year that the arrangement was in effect (see Pltf. Ex. 52, II–A. 689–690). The district court rejected this determination on the ground that Worthen's exercise of the option was "highly improbable" (Pet. App. A 11a). The testimony as to the improbability of Worthen's exercise of the option was based upon the availability of the option to renew the lease. Thus, that testimony does not affect our basic submission that petitioner had no significant ownership interest in the building (see text above). However, the record does support the district court's holding with respect to the includability of the aliquot portion of interest income. Accordingly, we did not appeal that aspect of the case to the court of appeals. Since the correctness of the district court's decision as to the interest income is not before this Court, there is no occasion for us to address petitioner's arguments (Br. 34–37) concerning this issue.

lion in deductible rent over the next 40 years (the present value of the rents over the extended term), simple economics would dictate that Worthen elect the latter alternative. Thus, in any event, Worthen will possess and control the building throughout its economic life.

It is, moreover, no answer for petitioner to argue (Br. 31) that Worthen would not extend the lease because it was "likely that Worthen would need another new building by the end of the 25-year period." If, as the record demonstrates, the extended term rentals are "very, very cheap," Worthen would be free to exercise the purchase option and sell the building, sell its leasehold interest or sublet the building to other tenants at a profit. The fact that Worthen may not occupy any part of the building itself after 25 years has nothing to do with the question whether it would extend the lease with petitioner. The opportunity for profit presented by the bargain renewal rentals refutes petitioner's assertion (Br. 33) that Worthen "loses nothing by walking away at the end of 25 years * * *."

2. The relevance of such an option to renew the lease is confirmed by the commentators and the case law. As early as 1948, before the lower courts began to apply the *Lazarus* standard to these arrangements, Professor Cary warned that "eminent counsel have been conservative and have advised a reasonably short-term lease, with very limited or no renewable rights"

Cary, *supra*, 62 Harv. L. Rev. at 26.[21] The subsequent lower court decisions proved the correctness of Professor Cary's observation.

A more recent commentary summarizes the case law as follows: "A second factor heavily relied upon by prior cases was the renewal rentals. Nominal renewal rentals taint a transaction. However, renewal rentals that are fixed in advance and are lower than initial term rental are acceptable if reasonable in the context of the transaction. Only unreasonably low renewal rentals are suspect because such rentals will effectively deprive the lessor of his ownership right to a fair payment for the use and occupancy of his property [footnotes omitted]." Rosenberg and Weinstein, *supra*, 45 Journal of Taxation at 150. Accord: *Starr's Estate* v. *Commissioner*, *supra*, 274 F. 2d at 296; *Mt. Mansfield Television, Inc.* v. *United States*, 239 F. Supp. 539, 541–542, 544 (D. Vt.), affirmed, 342 F. 2d 994 (C.A. 2), certiorari denied, 382 U.S. 818. *Frenzel* v. *Commissioner*, *supra*; Rev. Proc. 75–21, Sec. 4(2), 1975–1 Cum. Bull. 715, 716. Cf. *Midler Court Realty, Inc.* v. *Commissioner*, 521 F. 2d 767, 770 (C.A. 3).

Finally, our analysis of the option to renew the lease is supported by the standards recently promulgated by the accounting profession's Financial Accounting Standards Board. See FASB Statement of Financial Accounting Standards No. 13, Accounting for

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[21] *Lazarus* itself involved a 99-year lease that was renewable for a like period (see 32 B.T.A. at 634).

Leases 1–14 (November 1976).[32] Pursuant to those standards, a lease is classified as a "capital lease" and must be recorded as an asset on the books of the lessee if one or more of the following criteria are present: (1) the lease transfers ownership of the property to the lessee by the end of the lease term; (2) the lease contains a bargain purchase option; (3) the lease term (*including bargain renewal options*) is equal to 75 percent or more of the estimated period during which the property is expected to be economically usable by one or more users, with normal repairs; or (4) the present value at the beginning of the term of the lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the term over any related investment credit retained by the lessor (see *id.* at pp. 2–5, 9–10).

If the arrangement qualifies under any one of the foregoing criteria, it will qualify as a capital lease. But as we shall now show, the transaction meets at least the third and fourth categories if not the second category, of the Financial Accounting Standards Board. The arrangement here may not meet the first criterion because it does not, by its terms, automatically transfer title of the building back to Worthen at the end of the lease term. But even assuming *arguendo* that there is no bargain purchase option within the meaning of the second category, the ar-

[32] See also Gant, *Illusion in Lease Financing*, 37 Harv. Bus. Rev. (No. 2) 121 (1959); Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 Real Estate Law J. 664 (1974).

rangement would still be classified as a "capital lease" under the third and fourth criteria outlined above.

With respect to the third criterion, the 65-year lease term (25 year primary term and 40 year bargain rental term) is surely equal to 75 percent or more of the estimated economic life of the building. If this criterion were inapplicable, the building would have to have an economic life of more than 86⅔ years (65÷0.75) and it strains credulity to presume that the Worthen Building would be functional after 86 years without major renovation. Indeed, petitioner itself (Br. 31) cites the testimony of C. V. Barnes that after about 25 or 30 years, such buildings "had to have some extensive money spent on them to cure a problem, and certain functional problems you couldn't cure" (1–A. 241).

Under the fourth accounting criterion, it is equally apparent that the present value of the lease payments at the beginning of the term equals the principal sum of the New York Life mortgage of $7.1 million. If the value of the property at the inception of the term equaled its $7.6 million cost, the present value of the rentals during the primary term ($7.1 million) is more than 90 percent of the value of the property. It is 93 percent of the $7.6 million, without taking into account the value of the renewal rentals ($1.8 million—see p. 40 n. 26, *supra*).

In sum, even under the standards of the traditionally conservative accounting profession, which is normally reluctant to attribute ownership of an "asset"

unless there are strong assurances that the purported "owner" has unfettered control and use of the property, the Worthen Bank would be regarded as having the significant ownership interest in the building under a capital lease and petitioner would be classified as a party to a "direct financing lease." [33] Thus, accepted methods of accounting would likewise regard Worthen as the owner of the building in accordance with the economic substance of the transaction.

D. SINCE PETITIONER IS NOT THE TRUE OWNER OF THE BUILDING, IT CANNOT CLAIM DEDUCTIONS FOR MORTGAGE INTEREST OR DEPRECIATION

The foregoing discussion demonstrates that the pertinent judicial and scholarly authorities support the court of appeals' decision that the arrangement between petitioner and Worthen was a financing transaction and did not give rise to a true sale of the building from Worthen to petitioner. To the contrary, under the analysis of *Lazarus* and its progeny in the lower courts, the transaction was a $500,000 non-recourse loan (on the security of the building) from petitioner to Worthen to be repaid in either 25 or 65 years, at the election of Worthen.

[33] From the standpoint of the lessor (petitioner), the Financial Accounting Standards Board rules (*supra*, at pp. 8, 10) provide that a lease will be classified as a sales-type lease (one that gives rise to manufacturer's profit) or a direct financing lease if it meets any one of the four criteria discussed above and (i) collectibility of the rent is reasonably predictable; and (ii) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor. Here, both those latter conditions are met so that the lease would be classified as a direct financing lease.

1. *Mortgage interest.*—The court of appeals correctly held that petitioner cannot claim deductions for the interest paid on the New York Life mortgage. Petitioner's role was at best a conduit between Worthen and New York Life for transmission of the mortgage payments. However, petitioner's performance of this function does not give rise to an interest deduction."

It was Worthen that obtained the benefit of the amortization of the New York Life loan by reducing its option price on a dollar-for-dollar basis as the loan was amortized over its 25-year term. Moreover, like any mortgage debtor, Worthen guaranteed to New York Life that it would unconditionally make the "rental" payments (which exactly equaled the principal and interest) for the duration of the primary term and pledged its ownership of the land, parking facility, and easements as security for the New York Life loan. "Interest on indebtedness" within the mean-

[34] Petitioner argues (Br. 38–39) that the conduit analysis of the court of appeals is inconsistent with *Commissioner* v. *Brown*, 380 U.S. 563. There, the Court held that the transfer of the stock of a corporation to a tax-exempt charity followed by the charity's liquidation of the corporation and leaseback of the assets to a newly organized corporation owned by the transferor was a sale for tax purposes, despite the fact that the purchase price was to be paid out of the earnings of the corporation. But the ground of the decision in *Brown* was that there was an actual transfer of property for a fixed price upon payment of which "the Brown family would forever lose all rights to the income and properties of the company" (*id.* at 569). Here, however, Worthen did not transfer to petitioner "all rights" to the building; it only transferred bare legal title to secure the repayment of petitioner's $500,000 advance with interest.

ing of Section 163(a) of the Code "means compensation for the use or forbearance of money." *Deputy* v. *duPont,* 308 U.S. 488, 498. See also *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 560. Since Worthen enjoyed the use of the funds produced by the New York Life loan, it is Worthen and not petitioner that is entitled to deduct the interest paid on that mortgage.

Petitioner's sole claim to the mortgage interest deduction is based upon the form of the transaction, *viz.,* that (Br. 25) it "was solely liable on full recourse loans."[35] But the taxpayer's execution of a deed in *Lazarus* did not require the conclusion that a sale had occurred. As the Court there stated, "In the field of

[35] Petitioner also argues (Br. 44) that the conduit analysis of the court of appeals is, at all events, inapplicable to the interest paid on the interim City Bank construction loan. But that issue is not before the Court since the court of appeals, in response to petitioner's petition for rehearing, modified its opinion to provide for a remand to the district court for further findings with respect to petitioner's claimed deductions for interest on the interim construction loan and for miscellaneous additional expenses in connection with these agreements (Pet. App. D 32a–33a).

Moreover, the agreements between the parties appear to refute petitioner's claim to interest deductions on the interim construction loan. The sales agreement provided that "interim interest on the construction loan" would be credited to the $7.6 million "purchase price" under that agreement (Pltf. Ex. 25, II–A. 514). Moreover, Worthen included the interim interest in the list of costs "it has paid" that it submitted to New York Life (Deft. Ex. 11, II–A. 701, 704) and its accountants certified that such interest was "incurred and paid" by Worthen (Deft. Ex. 12, II–A. 705, 706). Thus, it appears that Worthen and not petitioner bore the economic burden of the interest on the interim construction loan.

taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering* v. *F. & R. Lazarus & Co., supra,* 308 U.S. at 255. Here, too, petitioner's role as the formal obligor on the New York Life note must be viewed in the context of the entire arrangement.

As part of the set of interlocking documents, Worthen executed a separate agreement promising New York Life that it would not terminate the lease[36] for any reason as long as the mortgage remained outstanding (Pltf. Ex. 29, II–A. 582). This promise, together with Worthen's consent to petitioner's asignment of the building lease as security for the loan, locked Worthen into the arrangement. Petitioner's obligation on the note was thereby effectively shifted to Worthen as an unconditional obligation owed to New York Life.[37] Moreover, as we have pointed out, *supra,* pp. 18, 36, Worthen agreed to pay its "rentals" directly to New York Life (Pltf. Ex. 29, II–A. 582).

[36] New York Life required, as a condition to its loan, that the building lease be acceptable to it (Pltf. Ex. 17, II–A. 358–362).

[37] If Worthen defaults on its obligations to New York Life, petitioner would be required to step in and satisfy the conditions of the mortgage. But until that event occurs, there is no basis to petitioner's claim to the deductions for the mortgage interest that Worthen has in fact paid for the use of the funds provided by New York Life. In this context, petitioner was an accommodation party to a loan effectively made to Worthen. Cf. *Nelson* v. *Commissioner,* 281 F. 2d 1, 5–7 (C.A. 5); *United States Fidelity & Guaranty Co.* v. *Commissioner,* 40 B.T.A. 1010, 1017–1019.

Under these circumstances, it is something of an overstatement even to characterize petitioner's role as that of a conduit, because it does not appear even to have actually received or transmitted the mortgage payments. Thus, apart from its formal execution of the mortgage note, petitioner performed absolutely no function with respect to the mortgage payments. There is accordingly no basis to petitioner's claim to deduct mortgage interest on the New York Life loan.[38]

2. *Depreciation.*—Just as petitioner is not entitled to deduct interest on the mortgage obligation that was effectively shifted to Worthen, it cannot claim depreciation deductions on the building encumbered by that mortgage. As Mr. Justice Brandeis explained for a unanimous Court in *United States* v. *Ludey,* 274 U.S. 295, 300, "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used." There is no doubt that the building subject to the arrangement at issue in this case is subject to wear and tear and is eligible for depreciation. The question, however, is which party to the transaction—Worthen or petitioner—can deduct that depreciation on its return.

[38] The Treasury Regulations support this analysis. See Treasury Regulations, Section 1.163–1(b) (26 C.F.R.), which provides that the "equitable owner" of property may deduct the interest paid on the mortgage even though he is not directly liable on the mortgage note itself.

Lazarus supports the decision of the court of appeals that Worthen and not petitioner is entitled to the depreciation deduction on the building. There, in considering the tax consequences of an essentially equivalent sale-and-leaseback transaction, the Court noted that the allowance for depreciation was intended to benefit the taxpayer that actually "bear[s] the burden of exhaustion of capital investment" (308 U.S. at 254), without regard to whether it holds legal title to the property. Here, Worthen stands on the same economic footing as the taxpayer in *Lazarus,* which purportedly sold and leased back its building. As we have shown, Worthen is effectively obligated to discharge the mortgage obligation on the building and will enjoy the benefits of the building over its entire economic life.[39] Under these circumstances, it is Worthen that made the economic investment in the building and thereby bore the burden of the exhaus-

[39] *World Publishing Co.* v. *Commissioner,* 299 F. 2d 614 (C.A. 8), upon which petitioner relies (Br. 22–23), is distinguishable. There, the taxpayer purchased property subject to a long-term lease, consisting of land and a building constructed by the lessee. The court held that the taxpayer could allocate a portion of the purchase price to the building and depreciate that amount over the remaining term of the lease. In the court's view, the taxpayer and the lessee each had "separate wasting investment[s]" meeting the statutory requirements for depreciation (299 F. 2d at 622). But cf. *M. DeMatteo Construction Co.* v. *United States,* 433 F. 2d 1263 (C.A. 1) (deduction denied where the term of the lease extended beyond the remaining useful life of the building). Here, however, only one wasting investment was made and, as we have shown, Worthen made that investment.

tion of capital investment in the building that is the prerequisite for the depreciation deduction.[40]

E. THE ARRANGEMENT IN THIS CASE WAS NOT THE PRODUCT OF ARMS LENGTH BARGAINING

In holding that the sale and leaseback in this case was a financing transaction and not a true sale, the court of appeals properly recognized that such transactions "are an accepted and useful means of controlling business property" and that its "opinion should not be read as a general condemnation of sale-leaseback arrangements" (Pet. App. B 30a). As Professor Cary observes, "[o]ne of the primary reasons presently given by companies for adopting the sale and leaseback is that they may thereby secure a larger aggregate amount of capital than through any other form of debt financing." Cary, *supra,* 62 Harv. L. Rev. at 5–6. Moreover, he points out that the arrangement enables a business to circumvent the legal restrictions

[40] Contrary to petitioner's further argument (Br. 27–30), the decreasing option purchase prices and the reduced rentals during the extended term do not show that petitioner bore the burden of the depreciation of the building. The decreasing option prices were geared to the ratable amortization of the mortgage. Indeed, from petitioner's standpoint, the option prices will steadily increase at a fixed rate of six per cent, compounded annually. Moreover, as we have shown (pp. 39–40, *supra*), the reduced rentals bore no relation to the declining value of the building but were likewise set to provide petitioner with a six per cent return on its $500,000 advance.

The only contingency under which petitioner would be entitled to depreciation deductions with respect to the building would be if Worthen declined to exercise the option either to purchase or to extend the lease. But even in that event, the only capital investment made by petitioner that would be subject to exhaustion would be its $500,000 outlay. Accordingly, its depreciations deduction would be limited to its $500,000 cost basis. See Section 167(g) of the Code.

imposed upon direct borrowing by bonds, term loan agreements, or preferred stock (*id.* at 14).

We do not dispute that the sale and leaseback in this case may have been prompted by the fact that banking regulations prevented Worthen from showing the building on its books as an asset (see pp. 4–5, *supra*). But this consideration did not dictate the particular details of the arrangement that provided petitioner with no "significant ownership interest" in the building (Pet. App. B 28a). The record shows that Worthen rejected other sale-and-leaseback proposals under which Worthen's repurchase option was not simply geared to a return of the outside investor's advance. (See p. 8 n. 7, *supra,* and p. 63 n. 43, *infra.*) Thus, the existence of a non-tax reason for entering into a sale and leaseback does not support petitioner's generalized assertions (Br. 15) that the "transaction should be taxed as it was structured by the parties" and that (Br. 21) the "tax laws should * * * take the transaction * * * as it finds it * * *."[41]

[41] Petitioner also complains (Br. 18) that the court of appeals "made it impossible for a future tax planner to structure such an arrangement with any confidence or security * * *." But the parties to such sale and leaseback arrangements may obtain an advance ruling from the Internal Revenue Service, which will appraise a proposed transaction in accordance with its published criteria. See Rev. Proc. 75–21, 1975–1 Cum. Bull. 715. See also Rev. Rul. 55–540, 1955–2 Cum. Bull. 39.

Moreover, parties to such arrangements can seek the advice of counsel. The record shows that Worthen sought legal advice as to the tax consequences of a sale and leaseback transaction with respect to the building and received comprehensive opinion letters setting forth the pertinent considerations under the *Lazarus* standard (Deft. Exs. 14, 15, II–R. 708–741). There is, however, nothing in the record that indicates whether petitioner received independent legal advice in connection with the transaction.

If such were the rule, the form of an arrangement would control its tax consequences as long as those consequences are in accord with the parties' expectations. But such a rule cannot be squared with the requirement of *Lazarus* that the economic substance of these sales and leasebacks must be examined on a case-by-case basis and that the formal nomenclature of the parties is not controlling for tax purposes. Indeed, petitioner's claim that the tax law must take its cue from the parties' understanding is refuted by this Court's statement in *Commissioner* v. *Duberstein*, *supra*, 363 U.S. at 286, that "* * * [i]t scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." Thus, the fact that petitioner and Worthen hoped to shift the mortgage interest and depreciation deductions to petitioner does not require that the Commissioner honor that expectation when the objective economic substance of the transaction shows that petitioner is not the owner of the building.[42]

In support of its argument that "[t]he tax laws should * * * take the transaction between the parties

[42] Petitioner argues (Br. 44–46) that the Commissioner's determination that Worthen owns the building for tax purposes is inconsistent with *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394. There, this Court held that the Commissioner could not exercise his authority under Section 482 of the Code to allocate insurance commissions to the taxpayer when it was prohibited by federal banking law from earning such commissions. Petitioner urges that (Br. 45) "it would similarly be illegal for Worthen Bank to own the building here in question" and that the Commissioner's position "amounts to a denial that banking regulations have tax 'substance' " (*ibid.*).

as it finds it * * *" (Br. 21), petitioner characterizes the arrangement as the product of "[H]ard, arms-length negotiations" (Br. 28). As petitioner views the matter, the allegedly adverse interests of the parties are sufficient to protect the revenue from "a sale of tax benefits" (Br. 17).

The record, however, does not support petitioner's characterization of the negotiations. Indeed, quite the contrary is the case. As the trial testimony demonstrates, the sale-and-leaseback transaction originated

But the federal banking law did not make it "illegal" for Worthen to "own" the building. The applicable statutory provisions simply required Worthen to obtain the approval of the Board of Governors of the Federal Reserve System to invest more than the amount of its capital stock in bank premises. See 12 U.S.C. 371d. Since the federal and state banking authorities approved Worthen's participation in the arrangement (Pltf. Exs. 40, 44, II–A. 612, 622), the rule of *First Security Bank of Utah* is inapplicable. Thus, the court of appeals correctly observed that its opinion "in no way affects Worthen's relationship to the Worthen building, as recognized by federal and state banking regulations" (Pet. App. B 30a).

At all events, in giving their approval to the transaction, the banking authorities did not purport to consider whether it was a true sale or a financing transaction in accordance with the criteria this Court established in *Lazarus*. Indeed, the fact that both the federal and state bank authorities described the arrangement as a "plan of financing" (II–A. 612, 622) strongly suggests that they were well aware that Worthen was undertaking a long-term debt obligation and was not simply a conventional lessee.

Finally, *First Security Bank of Utah* turned on "the inequity of attributing to the Bank's taxable income that they have not received and may not lawfully receive" (394 U.S. at 405). But that consideration is inapplicable here. The Commissioner's denial of petitioner's claimed mortgage interest and depreciation deductions was based upon the facts that petitioner did not benefit from the New York Life loan and did not make an investment subject to capital exhaustion.

solely with Worthen and Worthen dictated all of its terms. Petitioner's role in the "negotiations" was entirely passive.

Worthen's president testified that petitioner had "nothing whatsoever to do" with determining the substantive provisions of the contract (I–A. 155). After incorporating the "best part" of each of the offers it had received, Worthen formulated a counterproposal (Pltf. Ex. 13, II–A. 349–351) which petitioner immediately accepted (I–A. 143–144). Petitioner did not seek to obtain any additional benefits for itself. Instead, upon accepting the Worthen's counterproposal, Frank Lyon wrote to Worthen's president as follows (Pltf. Ex. 14, II–A. 352):

> Dear Ed:
>
> We have reviewed your proposal submitted to us yesterday. Unequivocably, we would like to accept it.
>
> However, we do not feel that this proposal is the best for Worthen Bank, therefore, we accept your proposal with one major change. Your lease payments for the first five years will be reduced by $21,000 annually. On the enclosed sheet we have listed the points contained in your specification for easy comparison of our amended proposal with your proposal.
>
> Ed, as you know already, we want very much to be of service to Worthen Bank.
>
> Yours truly,
>
> FRANK LYON COMPANY,
> /s/ Frank Lyon,
> FRANK LYON,
> *Chairman of the Board.*

A letter in which the lessor offers to reduce the rent proposed by the lessee hardly shows hard, arms-length bargaining. To the contrary, it demonstrates that there was no bargaining, much less arms-length bargaining, between Worthen and petitioner with respect to the details of the arrangement. Worthen dictated all of the terms and insured its complete control over the property for its economic useful life.[43] Petitioner in turn expressed its willingness to accept whatever Worthen proposed, and even volunteered further concessions to its own financial detriment. (see I–A. 71).[44] The parties were therefore in no sense adverse within the accepted meaning of that term.[45] From petitioner's

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[43] Thus, Worthen unilaterally chose the option purchase price and the bargain rentals during the extended term. In marked contrast, the Goldman, Sachs proposal called for a repurchase option based on fair market value (Pltf. Ex 9, II–A. 343). The Stephens proposal called for a fixed repurchase price at the end of the primary term substantially in excess of that provided for in the arrangement at issue. However, the record does not indicate how that price was computed.

[44] As we have pointed out (p. 10 n. 8, *supra*), petitioner's concession on the rent was unacceptable to New York Life, which insisted that the rent be equal to the principal and interest payments under the mortgage (I–A. 109). However, petitioner's $105,000 concession ($21,000 x 5) was reflected in increased interest charges on a loan from Worthen to petitioner (*ibid.*).

[45] *Commissioner* v. *Danielson*, 378 F. 2d 771 (C.A. 3), certiorari denied, 389 U.S. 858, and *Levinson* v. *Commissioner*, 45 T.C. 380, upon which petitioner relies (Br. 22), are therefore distinguishable. There, the courts held that the parties to a sales agreement of a going business cannot introduce parole evidence to contradict their written allocation of a portion of the purchase price to a covenant not to compete. In such a situation, the parties are bound by their allocation because their interests are adverse. The buyer can deduct the amount allocated to the covenant over its term and

(Continued)

standpoint, the prospect of $1.5 million of net tax savings from the depreciation deductions during the period 1969–1980 (Pltf. Ex. 36, II–A. 595) made it unnecessary for it to bargain over the details of the arrangement.

Finally, petitioner urges (Br. 17) that "there is no justification for scrambling the bargain between Lyon and Worthen" where "there is no differential in tax rate or any special tax circumstance affecting one of the parties." While there may be particular instances in which an audit of both parties to a sale-and-lease-

(Continued)
the seller must include those amounts in ordinary income. Thus, every dollar added to the covenant not to compete produces a permanent tax benefit for the buyer and an equal tax detriment to the seller.

Here, on the other hand, the parties are not in directly adverse positions. If the form of the arrangement were honored, the seller-lessee (Worthen) would be able to shift the depreciation deductions to the buyer-lessor (petitioner) but would receive the benefit of rental deductions equal to the sum of the mortgage interest and amortization. Thus, Worthen would be able to write off the building over a 25-year useful life, rather than the 45-year period suggested by the Service as an appropriate useful life for office buildings. See Rev. Proc. 72–10, 1972–1 Cum. Bull. 721, 731. As Professor Cary indicates, this is a major tax advantage to the seller-lessee in this type of sale and leaseback. See Cary, *supra*, pp. 18–19. If an accelerated method of depreciation is used, the net effect of the arrangement is a temporary "trade-off" by the lessee of the large depreciation deductions it would have had available in the early years in exchange for larger deductions in the latter years as the normally nondeductible mortgage amortization increases (see Pltf. Ex. 36, II–A. 595–596). At all events, *Danielson* and *Levinson* held only that the parties are bound by their allocation and not that the Commissioner would be required to accept an unrealistic allocation. Cf. *Copperhead Coal Co.* v. *Commissioner*, 272 F. 2d 45, 48 (C.A. 6); *F. & D. Rentals, Inc.* v. *Commissioner*, 44 T.C. 335, 345.

back transaction does not result in the collection of additional revenues for a given year, that fact is wholly coincidental and cannot serve as a reasoned ground for permitting the tax consequences of these long-term arrangements to follow the formal labels adopted by the parties. As we have noted (p. 64 n. 45, *supra*), these arrangements can be mutually advantageous to both parties. Moreover, we are advised by the Internal Revenue Service that in the large majority of these cases involving sale and leasebacks or equipment leasing, the parties are not in the same tax posture. Usually, the lessee has losses and cannot benefit from the deductions attributable to the ownership of property so it "sells" them to a high-bracket taxpayer such as petitioner in exchange for financing. In other cases, the lessee is a corporation whose effective tax rate is less than that of a wealthy individual. Thus, if the transaction is taxed in accordance with its actual economic substance, these differences in the tax brackets or taxable status of the parties will result in the collection of additional revenue.

II

THE COURT OF APPEALS CORRECTLY HELD THAT THE FEDERAL TAX CONSEQUENCES OF A SALE AND LEASEBACK PRESENT A QUESTION OF LAW

The court of appeals properly observed that "[i]n this case the allocation of interests between parties is spelled out in undisputed written documents" (Pet. App. B 24a). The court thereupon analyzed these doc-

uments and the undisputed testimony to determine whether in economic substance "the transaction between the taxpayer and the * * * bank, in written form a transfer of ownership with a leaseback, was actually a loan secured by the property involved." *Helvering* v. *F. & R. Lazarus Co., supra,* 308 U.S. at 255. After making the required analysis, the court concluded that "the benefits, risks, and burdens which * * * [petitioner] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes" (Pet. App. B 29a).

Petitioner contends (Br. 46–54) that the court of appeals improperly reversed the district court's decision in its favor because the "clearly erroneous" standard of Fed. R. Civ. P. 52(a) protected the district court's "detailed factual findings" (Br. 46) that the parties intended the transaction to be a sale and leaseback with option to repurchase.

But the court of appeals did not dispute the district court's finding as to the intent of the parties. Instead, the court of appeals held that where, as here, the allocation of interests between parties is spelled out in undisputed written documents, the characterization of the transaction for tax purposes "is the law obligation of the court as distinguished from its fact finding duties." *United States* v. *Winthrop,* 417 F. 2d 905, 910 (C.A. 5); *American National Bank of Austin* v. *United States,* 421 F. 2d 442, 451 (C.A. 5), certiorari denied,

400 U.S. 819. Thus, the court of appeals did not make new findings as to the intent of the parties in derogation of Rule 52(a). Rather, it held that, as a matter of law, subjective intent "is simply immaterial to the characterization of the transaction for tax purposes" (Pet. App. B 24a).[46]

In this respect, the decision below is in accord with the other courts of appeals that have held that the question whether such agreements are true sales or financing transactions is one of law. *American National Bank of Austin* v. *United States,* 421 F. 2d 442, 451 (C.A. 5), certiorari denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States,* 426 F. 2d 115, 117–118 (C.A. 6), certiorari denied, 400 U.S. 827; *Estate of Franklin* v. *Commissioner,* 544 F. 2d 1045, 1047 n. 3 (C.A. 9); *American Realty Trust* v. *United States, supra,* 498 F. 2d at 1198. See also *ABKCO Industries, Inc.* v. *Commissioner,* 482 F. 2d 150, 155 (C.A. 3). Thus, it is the objective economic substance of the arrangement and not the parties' sub-

[46] Petitioner also argues (Br. 46–47) that the court of appeals failed to give appropriate deference to the district court's findings (Pet. App. A 5a–6a) that the rent to be paid during the term of the lease and the option prices were reasonable. But as we have pointed out in Point I.C., *supra*, pp. 45–46, there is nothing in the record to support the district court's conclusion that the option prices were geared to fair market value. Moreover, the district court's findings with respect to the rents were based solely on the rents during the primary term and did not consider the bargain rents during the extended term. These bargain rents made it unnecessary for Worthen to exercise the option to purchase. By extending the lease, Worthen could exercise complete dominion over the building for its entire economic life.

jective intent that is controlling in these cases. "If the parties enter into a transaction which they honestly believe to be a lease but which in actuality has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it nor how they treat it on their books." *Oesterreich* v. *Commissioner*, *supra*, 226 F. 2d at 801–802."

American Realty Trust v. *United States*, *supra*, upon which petitioner relies (Br. 51–53) is not to the contrary. There, as here, the court of appeals examined the transaction in the light of the controlling legal standard established by this Court's decision in *Helvering* v. *F. & R. Lazarus & Co.*, *supra*. However, it concluded that the details of the arrangement were "sufficiently distinguishable from those in *Lazarus*" (498 F. 2d at 1199). It therefore held that there was sufficient evidence to support a jury verdict that the purchaser-lessor in a sale-and-leaseback transaction had an ownership interest in the property so as to be entitled to include the rental payments in its income and deduct the mortgage interest and depreciation, and to qualify as a real estate investment trust."

"Cf. *Benton* v. *Commissioner*, 197 F. 2d 745, 752 (C.A. 5). There, the court stated that "[i]f the parties in good faith actually intended to enter into a lease contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property." However, the Fifth Circuit has subsequently indicated that "the nomenclature used and the intent of the taxpayer cannot alone control the tax consequences of a particular series of transactions." *United States* v. *Henderson*, 375 F. 2d 36, 40. See also *Carlton* v. *United States*, 385 F. 2d 238, 243.

"Unlike this case, the rental payments in *American Realty Trust* were not equal to the principal and interest payments on the underlying mortgage so as to establish the conduit role of the lessor that exists here. Indeed, the agreement in that case provided that the rent was to be reduced by only 50 percent of the reduction in the mortgage payments. Moreover, the agreement in *American Realty Trust* personally bound the seller-lessee to pay the rent only for the first six years of the 21-year lease and permitted him to assign the lease thereafter (see 498 F. 2d at 1195). Here, however, Worthen had an absolute obligation to make the rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding. There was accordingly no realistic possibility that petitioner would bear the risks of the rental market for the building.

Furthermore, the lessor in *American Realty Trust* was entitled to 60 percent of any condemnation award over the sum of the mortgage balance, the lessor's cash advance, and the value of the tenants' leasehold estate (*ibid.*). Here, on the other hand, petitioner would receive no part of any condemnation award to the extent it exceeded the mortgage balance and its $500,000 advance.

Finally, unlike this case where Worthen could acquire title to the property either by exercising the repurchase option or by means of its reversionary interest, the lessee in *American Realty Trust* could only acquire title through the repurchase option. There, the court held that there was testimony tending to show that the lessee exercised his repurchase option "because of the sudden availability of 'wrap-around' financing, not because there was any 'economic compulsion' to repurchase inherent in the deal" (498 F. 2d at 1199). Given these distinguishing characteristics, the court of appeals in this case correctly concluded that "[t]he arrangement * * * [in *American Realty Trust*] was not nearly so thin and transparent as the present transaction" (Pet. App. B 29a). Accord: Rosenberg and Weinstein, *supra*, 45 Journal of Taxation at 151.

But in so holding, the court did not rule that the question of sale versus financing transaction was properly put before the jury as a question of fact. To the contrary, in considering the government's second argument that the documents established that the transaction was actually a loan as a matter of law, the court agreed that "[t]he characterization of the ques-

tion in issue as 'legal,' not 'factual,' admittedly has a basis in decisional law." It further observed that this Court in *Lazarus* "suggested that the determination of the *bona fides* of a sale-and-lease-back transaction involves, ultimately, a legal conclusion, albeit one grounded in underlying findings of fact [footnote omitted]" (498 F. 2d at 1198).

In sum, the variations inherent in sale-and-lease-back arrangements require that they be examined on a case-by-case basis under the economic substance standard of *Lazarus*. Results will necessarily differ in accordance with the details of the transaction. But the ultimate characterization of these arrangements for tax purposes presents a question of law freely reviewable by an appellate court. The court of appeals properly performed that function here and concluded on the undisputed facts of this case that "[t]he overall nature of this transaction is closely akin to that in [*Lazarus*]" Pet App. B 28a).

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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IN THE

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FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY MEMORANDUM FOR THE PETITIONER

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REPLY MEMORANDUM FOR THE PETITIONER

This reply to the Government's brief in opposition is filed because the Government has failed to face the important issues of equity, tax administration, and precedent presented by the decision below.

1. The principal difficulty with the position of the Government, and the approach of the court of appeals,

is the failure to recognize that taxpayers must plan, and that the Internal Revenue Service should tax such transactions in a fashion which is at least roughly predictable. On the practical as well as the conceptual level, it is proper that this transaction should be taxed as the parties understood it.

On the most simple common-sense level, the taxpayer and Worthen both had substantial and legitimate nontax motives for entering into the transaction and organizing it as they did.[1] They planned in good faith for certain consequences and bargained at arms length on those assumptions. And there is no practical reason not to tax the transaction as it was planned and structured. There is no revenue difference—corporate rates are flat rates and the Government will get the same tax from the petitioner, under its contention, as it would get from Worthen under the Government's contention. The Government's position is primarily formal—to no practical avail—while completely upsetting the reasonable expectations of the parties.

The Ninth Circuit in *Cubic Corporation* v. *United States*, 541 F.2d 829, recognized that the intention and situation of the parties should be a substantial factor in determining tax consequences; there should, in short, be some reason for upsetting good faith tax planning untainted by sham. The Government attempts to distinguish *Cubic* by pointing out that *Cubic* did not involve a sale and leaseback. But the Government fails to show any reason why the intent of the parties should be important in determining whether there was a "sale" in *Cubic* and yet irrelevant here. *See also*

[1] For instance, the terms of the agreement were formed to meet requirements of banking law, and by the competition among bidders.

American Realty Trust v. *United States*, 498 F.2d 1194, 1198-99 (4th Cir. 1974).[2]

2. There is no indication in the Government's brief of how the uncertain "bundle of sticks" approach adopted by the court below can be reliably or predictably used to discern the "economic substance" of a transaction.

In two footnotes (Brief in Opposition at 9-10, nn. 9, 10), the Government dismisses all consideration of predictability in general and fairness to the particular parties, observing that tax consequences must follow "economic substance." But here significant aspects of the "substance" of the transaction are given little or no weight. The Lyon-Worthen agreement was an *arms-length transaction* between two commercial actors, there was no *differential in tax rate* between the two parties, and both had *substantial nontax reasons* for entering into the transaction in its present form. Although there is no contention that the transaction is a "sham," or that tax avoidance was the objective or the result, the bargain is scrambled and the expectations of the parties frustrated.

3. The Government's position is that the Frank Lyon Company's share of the benefits and burdens of ownership is simply insufficient to allow it to take depreciation deductions.

[2] Earlier cases have likewise emphasized the importance of the intent of the parties in determining the "economic substance" of the transaction involved. *See, e.g., Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939); *Western Contracting Corporation* v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959); *Oesterreich* v. *Commissioner*, 226 F.2d 798, 801-802 (9th Cir. 1955); *Commissioner* v. *H. F. Neighbors Realty Co.*, 81 F.2d 173 (9th Cir. 1936).

The factual difficulties with this conclusion are outlined in the Petition at 13-16 and throughout the opinion of the district court. Pet. App. A. It is illustrative to note that the Government has made no attempt to explain away the 10-year period between the end of the building lease and the end of the ground lease.[3] During this period, Lyon was at liberty to use or rent the property as it wished while paying the specified ground rental of $10,000 per year. This residual interest makes it clear that petitioner was not a mere "conduit" for loan money as the Government and the court of appeals have asserted.[4]

[3] By citing this fact, petitioner does not, of course, accept the Government's characterization of the other burdens and benefits retained by Lyon. This terminal period is merely the clearest example of the Government's refusal to recognize any part of the "substance" of the transaction which does not comport with its own conceptualizations.

[4] The Government relies in its Brief in Opposition far more heavily on Worthen's reversionary interest in the building than did the court of appeals. In its statement of the question presented and in its discussion of *American Realty Trust*, *supra*, the Government states as fact its conclusion on reversion, though it is a disputed question of Arkansas law which the court of appeals stated that it "need not resolve". Pet. App. 27a, n.6. This question, too, materially affects the "conduit" theory on which the Government's case depends.

The common law rule cited by the Government—that improvements by a lessee revert to the owner at the end of the lease unless the lease provides otherwise—does not deal with the more complicated situation presented here, where the ground lessor has *sold* the improvement to the lessee without any reservation of reversionary rights.

Arkansas law clearly recognizes that one person may own the leased land and another may own the improvements thereon. In *Stirman* v. *Craven*, 33 Ark. 376 (1878), the Arkansas Supreme Court resolved the dilemma of dual ownership of the land and building after the termination of the lease by ordering the property sold and the purchase price divided in proportion to value. *Stirman* followed an earlier case, *Witherspoon and Gilliam* v. *Nichols, Sheriff*, 27 Ark. 332 (1871), was cited with approval in *Butler* v. *Adler—Goldman Commission Company*, 62 Ark. 445, 450, 35 S. W. 1110, 1111 (1896), and in *Storthz* v. *Sauger*, 108 Ark. 154, 161, 156 S. W. 1020, 1122 (1913) and has never been overruled or questioned.

Where the Government does attempt to meet the petitioners' arguments concerning the burdens and benefits of ownership which petitioner bears under the arrangement, its position ignores the practicalities of the situation. Thus, when petitioner points to the fact that it could have sold the building at a profit (Pet. at 16) the Government does not dispute the fact, it merely concludes that, since petitioner could not sell the land, sale profit would reflect appreciation of lease rights and not the building itself. (Brief in Opposition at 8, n.6). This hypertechnical distinction not only ignores rights beyond lease rights which would be conveyed (the right to resale and the other burdens and benefits of ownership which the petitioner points out in its brief), it fails totally to reconcile any appreciation on a sale with its "conduit" theory of petitioner's participation.

In a similar manner, the Government argues that petitioner could not realize any profit or loss on condemnation of the building because the lease required that petitioner pay over to Worthen the amount necessary to restore or replace the leasehold. (Brief in Opposition at 8, n.6). This argument ignores the possibility that the amount necessary to restore or replace the leasehold property may not be the same as the amount of insurance or condemnation proceeds.

Finally, the Government asserts that the risk of Worthen's insolvency is no different than the risk faced

by the guarantor of a loan. (Brief in Opposition at 9). This does not mean that the risk is not a risk of ownership. Nor does this argument deal with the possible opportunity presented by a Worthen insolvency if insolvency leaves the petitioner free to deal with a building that has appreciated in value free of the lease.

Moreover, the conclusion that Lyon was a mere conduit, and the factual determinations and assessment which support that conclusion, were fully rejected by the district court as trier of fact. (See Pet. App. A; Pet. at 7.) The district court found that the option prices represented a "negotiated estimate . . . as to fair market value of the building," but the Government simply rejects this finding. (Brief in Opposition at 7.) The Government is asserting that it understands the dynamics of the negotiation better than the trier of fact, and rejecting the plausible conclusion that the terms were what they were because competition for the investment opportunity put Worthen in a position to demand the terms on which the parties agreed. Pet. at 7; Pet. App. A 13a, 10a.

4. A full appreciation of the facts is necessary to determine the "economic substance" of a transaction. The Government's position—that "economic substance" can and should be determined as a pure matter of law—is a dangerous misreading of the law.

The cases cited by the Government (Brief in Opposition at 13) can be taken as supporting the proposition that when the facts are established the determination of the question whether such agreements are to be taxed as sales or financing transactions is ultimately a legal conclusion. The cases cited do not support the idea that courts of appeals should determine the

facts *de novo* in utter disregard of the findings of the trier of fact; yet this is what the Government seeks here, because in *Lyon,* the findings of the district court upheld the taxpayer at every point.

Although the Government cites *American Realty Trust* v. *United States,* 498 F.2d 1194 (4th Cir. 1974), for instance, the *American Realty Trust* court dealt only in the alternative with the Government's contention that a sale-leaseback could be dealt with *de novo* as a matter of law. The court had declared itself "disinclined to disturb the jury's verdict" since there was enough supporting evidence to preclude a conclusion that the verdict on the sale or financing arrangement question was clearly erroneous. 498 F.2d 1198. The ultimate conclusion may be legal but it must be "grounded in underlying findings of fact." 498 F.2d at 1198.

The *American Realty Trust* court's treatment of the issue as a whole, with its full recognition of the importance of the factual findings and the intent of the parties, provides sharp contrast to the decision of the court of appeals here, and the approach the Government urges on this Court. The two approaches, with their conflicting signals to tax planners, cannot be reconciled except by this Court.

5. In its discussion of this Court's decision in *Commissioner* v. *First Security Bank of Utah,* 405 U.S. 394, the Government has simply scrambled what went on when this transaction was carried out. It says (Brief in Opposition 12-13): "Since the federal and state banking authorities approved the sale and leaseback transaction (*See* Pet. App. A 4a), the rule of *First Security Bank* is inapplicable here."

Yet, it is entirely clear that both federal and state banking authorities refused to approve an arrangement under which Worthen would be the owner of the building.[5] It was because of this that Worthen decided to sell the building to the petitioner, and then to lease it back. It is true that the state and federal banking authorities approved this transaction; but the very reason that they did so was because Worthen was *not* the owner of the building under the agreement between the parties. To say that the petitioner should now be taxed as if Worthen was the owner of the building, and that "*First Security Bank* is inapplicable here" is to stand the transaction on its head. What the banking authorities approved was an arrangement in which Worthen was the lessee. This was the view of the court of appeals. Pet App. 16a. For the Government now to say that "The Federal banking law does not prohibit Worthen from borrowing the money but simply required it to seek the approval of the regulatory authorities" (Brief in Opposition 12), when the Federal banking authorities had expressly disapproved an arrangement under which Worthen borrowed the money and was the owner of the building, is disingenuous.

[5] In footnote 3, page 4, of its Brief in Opposition, the Government erroneously stated that the State Bank Department required a repurchase option at the end of the 15th year of the lease, "but did not otherwise specify the terms of the agreement." It is questionable whether the State Bank Department would have approved an option price at fair market value rather than an agreed upon "figure" or dollar amount.

CONCLUSION

The Government has failed here, as the court of appeals failed below, to reconcile the decision below with the findings of the district court, with applicable precedent, or with the dictates of practical foreseeability and sound tax administration. In order to provide badly needed clarity in this field, the Court should grant the petition for certiorari.

Respectfully submitted,

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February, 1977

SUPREME COURT, U.S.

Apr. 16	Transcript of Trial proceedings, filed.
Sept. 1	Opinion, filed (Madden). Copies mailed.
Sept. 21	Judgment of Dismissal in Favor of the defendant The United States of America, and against the Plaintiff Leeds and Lippincott Company, with costs, filed (Madden). Notice mailed.
Oct. 7	Letter waiving all costs except Attorneys' Docket Fee, filed.
Oct. 7	Defendant's costs taxed at $20.00, filed.
Oct. 19	Notice of appeal, filed Oct. 15, 1959 (copies mailed Clerk, USCA and U. S. Attorney).
Oct. 19	$250.00 deposited in Registry of Court and Bond for Costs on Appeal, filed 10-15-59.

OPINION.

(Not for Publication.)

(Filed Sept. 1, 1959.)

APPEARANCES:

For Plaintiff: JAMES N. BUTLER, Esq.; Of Counsel: CONVERSE MURDOCH, Esq., and KENNETH W. GEMMILL, Esq., both of Pennsylvania Bar.

For Defendant: CHESTER A. WEIDENBURNER, Esq., United States Attorney; FRANK J. FERRY, Esq., Assistant United States Attorney; CHARLES K. RICE, Esq., Assistant Attorney General; JAMES P. GARLAND, Esq., and FRED J. NEWLAND, Esq., Attorneys, Department of Justice.

MADDEN, District Judge:

This is a suit instituted by plaintiff, Leeds and Lippincott Company, a corporation of New Jersey, hereinafter referred to as taxpayer, to recover federal income taxes for the years 1950 and 1951 allegedly paid in error to the Collector of Internal Revenue for the District of New Jersey. Claim for refund was properly made and no disposition thereof having been made within six months this suit was instituted in accordance with the statute.

The facts of this matter, with the exception of a comparatively minor detail, are not in dispute and are covered by two stipulations entered herein. While some portions of the stipulations are agreed to in fact they have been objected to upon the grounds that such portions are neither material nor relevant. In passing, the Court has considered all portions thereof as properly admitted.

Plaintiff-taxpayer in 1950 was the owner of boardwalk hotel properties in Atlantic City, New Jersey, known as the Chalfonte-Haddon Hall. These two hotels are actually contiguous to each other, both fronting on the boardwalk, with the Chalfonte on the westerly side of North Carolina Avenue and the Haddon Hall on the easterly side of the same street. It might be well to keep in mind that at this particular location the boardwalk runs generally east and west with the ocean to the south and the land side to the north. On North Carolina Avenue at a point approximately 667 feet north of the boardwalk, running roughly parallel thereto and at right angles or perpendicular to North Carolina Avenue, there is a 20 foot wide street called Chalfonte Avenue which runs the width of the block between North and South Carolina Avenues. Between this street, Chalfonte Avenue, and the rear portion of the Chalfonte Hotel structure are located the particular properties involved in the issue herein joined. These properties consist of the following:

#1. Brick garage of 13 levels for housing the automobiles of the hotel guests capable of accommodating between 240 and 260 vehicles.

#2. New power house. This 6-story building houses a varied number of hotel services. The first floor houses all the necessary machinery for supplying electricity to both hotels. In the basement there are two artesian wells which supply all the water for all buildings of the hotels, together with a large reservoir tank for the storage thereof. On the second floor there is a carpenter shop and paint shop. The third floor contains all the heating equipment for heating all the hotel facilities. The fourth floor is used for storage while the fifth floor contains a complete laundry which services the hotels. The sixth floor is divided into rooms and serves as a dormitory for the taxpayer's male employees.

#3. Old power house used as a utility building for painting and storage.

#4. Sands Hotel (located at the corner of Chalfonte and South Carolina Avenues). This is a 6-story brick and frame hotel having 5 stores, 92 bedrooms and 23 baths. It is used principally for housing the taxpayer's female employees and can accommodate about 143 women.

#5. Martin's cottage. This is a 3½-story frame building containing 7 bedrooms and 2 baths and an apartment of three rooms and a bath.

#6. Keystone. This is a 4-story brick and frame building containing a store, 41 bedrooms and 6 baths. It is used for housing the male employees of taxpayer.

#7. This parcel consisted of properties known as Rydal, Warwick and Cedarcroft Hotels. They were small hotels fronting on South Carolina Avenue and have since been demolished.

In addition, there is a tunnel running beneath the surface of the ground starting in the Haddon Hall to the east and going under North Carolina Avenue to the new power house on the west.

These properties for the present purposes can be called the service facilities.

In 1937, the taxpayer was reorganized in this Court under Section 77B of the Bankruptcy Act. It possessed a total indebtedness of $7,906,336, including a first mortgage of $4,100,000 on Haddon Hall held by Prudential Insurance Company which was due January 1, 1952, and a first mortgage of $2,550,000 on the Chalfonte held by Camden Trust Company which was due January 1, 1952.

On December 31, 1951, the aforementioned debt of the taxpayer was reduced approximately by two million dollars leaving a total indebtedness of $5,999,635.61 of which there was still due to Prudential, $3,365,228.46 on its mortgage (a reduction of $734,771.54), and to Camden Trust, $1,960,440.00 on its mortgage (a reduction of $589,560.00).

These two mortgages, together with a chattel mortgage having a balance due of $73,964.28, were due for payment January 1st, 1952, and the taxpayer explored various possibilities for refinancing its obligations. The Camden Trust Company refused to renew or extend its mortgage, and by the fall of 1951 it became apparent to the taxpayer that it would be impossible to obtain a completely satisfactory refinancing of its debt structure. Taxpayer had secured a commitment from the Donner Foundation for a mortgage loan on the Chalfonte Hotel of $900,000 but the placing of this loan cost the plaintiff-taxpayer $175,000 in discount and placement fees. It attempted to secure a mortgage loan from Prudential of $825,000 on the hereinbefore described service facilities. (Prudential had agreed to extend its mortgage on Haddon Hall five years, until January 1st,

1957, and set the interest rate at 4½%.) Prudential informed the taxpayer that under applicable (State of New Jersey) insurance regulations it would be impossible to give an $825,000 mortgage loan on the service facilities but that they would purchase these properties for $825,000 and lease them back to taxpayer for twenty years at an annual rental of $66,000, together with a right in the taxpayer to repurchase.

On December 27, 1951, there was executed by Prudential and the taxpayer a lease agreement whereby Prudential leased to the taxpayer the service facility properties for a period of twenty years commencing January 2, 1952, for an annual rental of $66,000. Among other things, the agreement provided that the taxpayer was required to pay all real estate taxes, assessments, water rates, insurance, utilities and repairs and that the taxpayer could make such alterations and improvements to the buildings, fixtures and equipment which may be necessary or desirable. The agreement also provided that the taxpayer at any time during the term thereof had the right or option to repurchase the service facilities for the original purchase price of $825,000 less the sum of those portions of the monthly installments of rent theretofore paid, as if such rentals were allocated, first, to interest at 5% per annum calculated on the declining monthly balances, and the balances of the monthly payments of rent in reduction of the principal sum of $825,000, but in no event was the repurchase price to be less than $5,000. On December 28, 1951, the taxpayer conveyed the premises known as the service facilities to Prudential by warranty deed.

The transaction was thereafter treated by taxpayer on its books and accounts as a mortgage and the $825,000 received therefrom was entered as a liability. (See Par. 10, Stipulation.) Taxpayer, until March, 1955, treated the

transaction in its federal income tax returns as a mortgage, deducting for depreciation and interest paid on such service facilities. (See Par. 9, Stipulation.) Prudential, on its books and records and its income tax returns, treated the same as a sale. (See Par. 11, Stipulation.)

In March, 1955, taxpayer changed its legal position with the Director of Internal Revenue regarding this transaction and adopted the position that the transaction was a sale wherein it suffered a capital loss, and, consequently, at that time, filed claims for refund for the years 1950 and 1951 to recover the carry-back loss it had sustained in those years. When the Director did not dispose of the claim within six months taxpayer instituted suit.

All the above facts have been entered upon the record before the Court by Stipulation. At the time of trial the taxpayer-plaintiff rested upon the record. The government by way of defense produced a real estate expert, Edward B. Gottleib, who appraised the properties in question, as of December, 1951, and placed a valuation thereon of $1,364,539.37, together with the stipulated value of the machinery and equipment contained in the service facilities of $91,000, or a total of $1,455,539.37. Thereafter, the taxpayer-plaintiff called as a rebuttal witness H. G. Myers, likewise a real estate expert, who appraised the facilities in question, as of December, 1951, and placed a valuation thereon of $795,300, together with the stipulated $91,000 for machinery and equipment, making a total of $886,300 for the properties transferred. With this, counsel rested and have briefed the matter to the Court.

The sole question before the Court appears to be, Was the transaction hereinbefore described a sale or a mortgage? It is the contention of the taxpayer that it is, under the tax laws, a sale and they are entitled to receive credit for a capital loss. On the other hand, it is the contention

of the government that this was, in effect, a mortgage transaction and the taxpayer is not entitled to credit for a capital loss.

The applicable tax statute is Section 117(j) of the Internal Revenue Code of 1939 and reads, as follows:

> "(j) (as added by Sec. 151(b), Revenue Act of 1942, supra)
> *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—
>
> "(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.
>
> "2. *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets."

The leading case in this particular field is Helvering v. Lazarus, 308 U. S. 252 (1939), wherein the Supreme Court affirmed a decision of the Board of Tax Appeals which upheld a taxpayer's claim for allowance of a deduction for depreciation in computation of income tax. The Court stated at page 255:

> "We think the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease back, was actually a loan secured by the property involved. General recognition has been given the 'established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money'. In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding."

It is generally stated and counsel have cited a number of cases to the effect that in determining whether a particular transaction constitutes a mortgage or a sale the primary factor for consideration is the intention of the parties.

A reading of the cases cited by counsel following the Lazarus case, supra, leads one to the conclusion that each particular transaction must be examined for all the surrounding facts in order to reach a determination of whether it constitutes a legal sale or mortgage. Such an examination leads this Court to the conclusion that the transaction

herein, while in form a sale, was in fact a mortgage with the conveyed property as security for the debt.

In reaching such a determination the Court has attempted to view all factors in the matter. The picture presented in the view of the Court is, as follows:

In 1938, the taxpayer was re-organized through bankruptcy proceedings with a total capital debt of close to $8,000,000. It was in the hotel business with two contiguous hotels and the service facilities (hereinbefore described) as its capital assets. It produced its own water, heat and light. It operated its own laundry and, in the main, housed its own employees and garaged the cars of its guests. In January, 1952, the greatest portion of its capital debt became due and it was seeking either extensions thereon or refinancing.

In the meantime it had reduced its capital debt by close to $2,000,000 (from $7,906,336 to $5,999,635.61) and at the same time it would be fair to assume that the properties of the taxpayer had increased in value, or, at the very least, had not decreased in value. As a result its comparative financial picture was 25% better than it was in 1938.

Prudential held the mortgage on the Hotel Haddon Hall. Camden Trust Company held the mortgage on the Hotel Chalfonte. Camden Trust Company would not renew or extend its mortgage so the taxpayer, in addition to making arrangements for the extension of the Prudential mortgage, had to secure $1,960,440 in order to pay off the Camden Trust Company. It secured a commitment for $900,000 from the Donner Fund for a mortgage on Chalfonte, but this cost $175,000. It, therefore, had to secure $825,000 from some other source. Taxpayer turned to the lending institution familiar to it and its problems, namely, Prudential. Prudential explained why it could not advance the money on a straight mortgage but could make available the money in the manner hereinbefore described.

The arrangements were entered into and the transaction completed. In the mind of the taxpayer at that time it was a loan, for it was so treated on the taxpayer's books and income tax returns.

It is argued by the taxpayer that such action was taken upon the advice of counsel and upon the advice of its Certified Public Accountant and that such advice should not foreclose taxpayer from asserting its true position or constitute a bar to such assertion. This Court would not feel that this act, taken alone by the taxpayer, would constitute a bar to the relief it presently seeks, but it does feel that it is a fact to be taken into consideration with all other things to show the intention of the taxpayer at the time of the transaction.

There is no evidence in this record that the taxpayer had any appraisal made of the true sale value of the service facilities transferred prior to the transaction hereinbefore discussed. Is it reasonable to assume that the taxpayer would involve itself in the outright sale of all of its service facilities without availing itself of a fair appraisal of their true value? This Courts feels it is not.

There is no evidence in the record before the Court that the taxpayer made any kind of a survey before entering into this transaction of what it would cost taxpayer to subcontract for the services produced by the facilities transferred, for instance: What would it cost for water? What would it cost for laundry? Could parking facilities be obtained and at what cost? What facilities would be available for storage and repair of furniture? What would be the result of not furnishing living quarters to its help? How could they possibly obtain heat for the two hotels from some other source? What effect would these services and the cost thereof obtained from outside sources have on the operating profit or loss of the taxpayer? Is it reasonable

to assume that the taxpayer would enter into an outright sale of such facilities without first making such inquiries and survey? The Court feels that it is not.

Despite the apparent form of the transaction as a sale, the plaintiff-taxpayer continued to assume all the rights, duties and obligations of ownership to the property. It must, by the terms of the lease, pay all real estate taxes, assessments, water rates, insurance, utilities, and repairs, and can make such alterations and improvements to buildings, fixtures, and equipment which may be necessary or desirable on its part.

The repurchase price to be paid by the taxpayer is equivalent to the $825,000 on a 20-year amortizing mortgage at 5% interest plus $5,000. Is this any more than a small bonus such as would be provided for upon the pre-payment of a mortgage?

Taxpayer argues that it paid the $907.50 for the Federal Documentary Tax Stamps affixed to the deed and that this factor should be seriously considered by the Court. It seems that this pales into insignificance when it is realized that the taxpayer paid $175,000 for the mortgage of $900,000 from the Donner Fund.

Taxpayer argues that one of the conditions of the repurchase agreement was that it must pay off any balance due and owing to Prudential on the mortgage held by Prudential on Haddon Hall and that this further indicates that the transaction under consideration was a sale in fact and not a loan. The Court feels that the contrary conclusion is the more reasonable or logical one to be drawn from such circumstance. Here is a creditor and debtor relationship and the creditor, in effect, saying, now before you completely pay me off on the second debt and obtain your release (of the repurchase of the service facilities) you must also pay off the first debt.

Plaintiff-taxpayer argues, "If expert testimony as to Fair Market Value of the Property is to be admitted, the testimony of defendant's expert witness is entitled to little, if any, weight," and further, "If expert testimony as to Fair Market Value is to be admitted, the testimony of plaintiff's expert witness should be accepted."

The Court feels that the testimony regarding value is admissible but is not conclusive. It is merely an additional fact to be taken into consideration in viewing the entire picture. Naturally, the weight and credit to be given to the testimony of the two experts is for the trier of the facts, in this matter, the Court. The Court finds from a careful analysis of both experts' testimony that the testimony of the witness Gottleib is entitled to more weight and seems to be more convincing. He approached the problem with greater soundness. He did not speculate on things that did not concern him and he did not appear to have any interest in the case. On the other hand, the Court, with reluctance, cannot say the same for the witness Myers. This is best illustrated by an excerpt of his testimony, pp. 60, 61, 62, transcript:

> "Q. Well, isn't it a fact, Mr. Myers, that these facilities were a necessary adjunct to the hotel?
>
> "A. I have always thought that they could very well do without that power house. They can buy current for less than they make it.
>
> "Q. It was being used by the hotel as a power house, the garage was being used, and all the other hotels were being used so that you could not sell that property separately? You could not sell that property separately if you left the power house and sold the other property on South Carolina Avenue, isn't that the situation?
>
> "A. No, I would not say that about South Carolina

Avenue because that property could have been sold, and they would have the cost of housing their employees. All the other hotels didn't house their employees, but they did. And so far as the garage, they could certainly operate without the garage because other hotels operate without garages. If they operated without the power house building and the laundry, then they would have to make plans to send the laundry out, and to house their men in dormitories elsewhere, and obtain their current from the Atlantic City Electric Company. It isn't my judgment but I heard this from Mr. *Henry* that it cost them ten cents a kilowatt hour to make it, and they could buy it for two cents.

"Q. The power house was being used by the hotel, and the garage was also being used by the hotel?

"A. Yes.

"Q. And it was adaptable to their use because of the new dormitory to the rear, in the rear of this hotel?

"A. Yes, but they have, I presume they have immediately to the east a terrifically large parking lot where the Strand Hotel used to stand.

"Q. Yes, but that is not part of Haddon Hall?

"A. The Haddon Hall has a chance to use it as a parking lot. If they could not use that garage, they could use the parking lot.

"Q. Now, when was that appraisal made that you just testified about?

"A. Well, it was made sometime in 1958. I don't recall what month. I may have some stuff lying around here with that in it. I made it in May, 1958. I have here a letter of May 16th addressed to Mr. Murdoch."

In addition, Mr. Myers participates in the commission on insurance premiums on the hotel properties.

The Court does not give great weight to the testimony of either expert in view of their difficult task of attempting, in 1957 and 1958, to make an appraisal and give a valuation as of 1951. It attaches more significance to the lack of an appraisal or actual evaluation of the facilities by the taxpayer prior to their transfer.

Lastly, it is, in the Court's estimation, of great significance that the lease containing the repurchase or option right was signed by Prudential December 27, 1951, (see Par. 8, Stipulation), the day before the execution of the deed, December 28, 1951, (see Par. 6, Stipulation). This fact indicates to the Court that the taxpayer wanted to be assured of the legal right to have possession, control and ability to regain title before the transfer to Prudential and was secure in its position by having Prudential execute the lease before it, the taxpayer, would execute the deed.

These facts, reviewed herein by the Court, may not have the same significance to other viewers, or, other facts in the matter not reviewed here may be more important to others than those herein set forth, but it seems to the Court that at the very least these are the important factors and they all seem to point in the one direction, namely, the creation of a debt and the transfer of these service facilities as security therefor. For the foregone reasons the plaintiff's claim will fall and the action will be dismissed.

Counsel will prepare an appropriate order.

/s/ THOMAS M. MADDEN.

9/1/59

JUDGMENT.

The above-entitled cause having come on regularly for trial before this Court on February 9, 1959, the Honorable Thomas M. Madden presiding therein, sitting without a jury, plaintiff and the defendant appearing by their respective attorneys, and some of the facts having been stipulated by written stipulation entered into between the parties and filed herein, together with documentary evidence and oral testimony submitted in behalf of each party, and briefs having been filed by and in behalf of the respective parties, and the Court, having duly considered the same and having rendered its opinion and decision on September 1, 1959, in favor of the defendant, ordering dismissal of this action, it is therefore

ORDERED, ADJUDGED and DECREED that the complaint filed herein be dismissed, with costs, if any, to be assessed against plaintiff.

/s/ THOMAS M. MADDEN,
United States District Judge.

Entered September 21, 1959.
Approved as to form:
/s/ CHESTER A. WEIDENBURNER,
United States Attorney.
/s/ FRANK J. FERRY,
Assistant United States Attorney.
/s/ JAMES N. BUTLER,
Attorney for Plaintiff,

Vol 3

8302

Table of Contents

15 12-76

Section		Paragraph
4050	Leases	
4053	Accounting for Leases	
	Introduction	.001-.004
	Standards of Financial Accounting and Reporting:	
	Definitions of Terms	.005
	Classification of Leases for Purposes of this Statement	.006
	Criteria for Classifying Leases (Other Than Leveraged Leases)	.007-.009
	Accounting and Reporting by Lessees	.010-.016
	Capital Leases	.010-.014
	Operating Leases	.015
	Disclosures	.016
	Accounting and Reporting by Lessors	.017-.023
	Sales-Type Leases	.017
	Direct Financing Leases	.018
	Operating Leases	.019
	Participation by Third Parties	.020-.022
	Disclosures	.023
	Leases Involving Real Estate	.024-.028
	Leases Involving Land Only	.025
	Leases Involving Land and Building(s)	.026
	Leases Involving Equipment As Well as Real Estate	.027
	Leases Involving Only Part of a Building	.028
	Leases Between Related Parties	.029-.031
	Sale-Leaseback Transactions	.032-.034
	Accounting and Reporting for Subleases and Similar Transactions	.035-.040
	Accounting by the Original Lessor	.036-.037
	Accounting by the Original Lessee	.038-.039
	Accounting by the New Lessee	.040
	Accounting and Reporting for Leveraged Leases	.041-.047
	Effective Date and Transition	.048-.051
	Appendix A: Background Information	.052-.058
	Appendix B: Basis for Conclusions	.059-.120
	Appendix C: Illustrations of Accounting by Lessees and Lessors	.121
	Appendix D: Illustrations of Disclosure by Lessees and Lessors	.122
	Appendix E: Illustrations of Accounting and Financial Statement Presentation for Leveraged Leases	.123

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REVENUE AND EXPENSE

. . . unrealized profit . . . installment method . . . construction-type contracts . . . government contracts . . . leases . . . compensation . . . pension plan costs . . . deferred compensation . . . depreciation . . . real and personal property taxes . . . income taxes . . . interest . . . research and development . . . contingencies

TABLE OF CONTENTS

Section		Paragraph
4010	Unrealized Profit	
4020	Installment Method of Accounting	
4030	Construction-Type Contracts	
4031	Long-Term Construction-Type Contracts	
	Generally Accepted Methods	.03
	Percentage-of-Completion Method	.04-.08
	Completed-Contract Method	.09-.14
	Selection of Method	.15
	Commitments	.16
4040	Government Contracts	
4041	Cost-Plus-Fixed-Fee Contracts	
	Summary Statement	.02-.05
	Discussion	.06-.09
	Major Accounting Problems	.10-.22
4042	Renegotiation	
	Treatment in Financial Statements	.06-.07
	Renegotiation Refunds for Prior Years	.08

Supreme Court, U. S.
FILED
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No. 76-624

In the Supreme Court of the United States

OCTOBER TERM, 1977

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

SUPPLEMENTAL MEMORANDUM FOR THE UNITED STATES

WADE H. MCCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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SUPPLEMENTAL MEMORANDUM FOR THE UNITED STATES

On September 7, 1977, the Third Circuit in *Commissioner* v. *Sun Oil Co.*, No. 76-2388, upheld the government's position that a sale-and-leaseback arrangement was a financing transaction and not a true sale. It therefore disallowed the rental payments claimed as a business expense deduction by the purported lessee. The Third Circuit discusses both this Court's decision in *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, and the court of appeals' decision in this case in the context of an analogous transaction. For the convenience of the Court, we have set forth the *Sun Oil Co.* opinion in the Appendix to this memorandum.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

SEPTEMBER 1977.

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 76-2388

SUN OIL COMPANY, TRANSFEREE, SUNRAY DX OIL COMPANY AND SUBSIDIARIES, TRANSFEROR,

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

Argued May 5, 1977

Before SEITZ, *Chief Judge*, and *ROSENN*, *Circuit Judge*, and LORD, *Chief Judge**

MYRON C. BAUM,
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* Joseph S. Lord, III, Chief Judge of the Eastern District of Pennsylvania, sitting by designation.

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OPINION OF THE COURT

(Filed Sep. 7, 1977)

ROSENN, *Circuit Judge*

In the quest to obtain capital, to generate business liquidity, or to minimize taxes, private enterprise often resorts to the sale of property and a simultaneous leaseback to the seller. A recurring question in transactions of this sort is whether after the transfer of title to the property some or all of the critical incidents of ownership still remain with the grantor despite his newly designated status as lessee.

This case concerns conveyances of 320 parcels of unimproved service station sites at cost by Sunray DX Oil Company ("Sunray") to a tax-exempt trust and simultaneous leasebacks to the grantor. The sole question is whether the transaction was a mere financing arrangement between the parties or an authentic sale. The Commissioner disallowed Sunray's deduction of its rental payments on the ground that the transaction did not constitute a true sale and that

the rental payments were not a bona fide business expense deductible under section 162(a)(3) of the Internal Revenue Code of 1954 ("the Code").[1] In a proceeding for redetermination of the deficiency brought by Sun Oil Co., Sunray's successor in interest, the United States Tax Court held that the rental payments were deductible. The Commissioner appealed and we reverse.

I.

During the taxable years in issue (1965-1968), Sunray, together with its subsidiaries and predecessors, was an integrated oil company engaged in all phases of the petroleum business, including marketing of petroleum and petroleum products. It was merged on October 25, 1968, into Sun Oil Company, a New Jersey corporation which was subsequently restructured as the Sun Oil Company, the appellee taxpayer herein. During the 1950's and early 1960's Sunray was actively involved in acquiring service station sites primarily in seventeen central states along interstate highways and in certain urban areas.

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[1] Section 162(a)(3) of the Internal Revenue Code of 1954 provides in part that,

> (a) In general.—there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including— . . . (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For a variety of business reasons, Sunray concluded that the most preferable means of obtaining working capital would be to convey its service station sites and then simultaneously lease them back rather than to mortgage the properties and incur a debt obligation on its books. After deciding to pursue this course of action, Sunray ascertained that General Electric Pension Trust (the "Trust") was interested in taking title to the properties, advancing funds to Sunray equal to the cost of the properties, and then entering into lease agreements with Sunray on a long term basis together with options to purchase.[2]

After extensive negotiations concerning terms and conditions of the proposed sale and leasebacks, Sunray and the Trust entered into their first letter agreement, dated October 13, 1964, under the terms of which Sunray agreed to convey by general warranty deed and the Trust agreed to purchase approximately 120 service station sites. The agreed purchase price for the parcels of land, mostly unimproved, was equal to Sunray's cost[3] of acquisition and in the

[2] The General Electric Pension Trust is a fiduciary trust to which the General Electric Company and its affiliates contribute funds pursuant to plans of deferred compensation which meet the requirements of section 404(a) of the Code and qualify the Trust for exemption from federal income taxes. The Trust had assets of approximately two and one-half billion dollars at the time of the tax court hearing in this case. No relationship whatsoever existed between Sunray and the Trust prior to the sale and leaseback transaction now under consideration.

[3] Sunray agreed to convey the properties at cost because it believed there would be no substantial difference between the

aggregate was not to exceed six million dollars. Simultaneous with purchase, Sunray agreed to lease the properties from the Trust for a primary term of 25 years with quarterly rentals sufficient to enable the Trust to amortize its investment in full over such initial term at an interest return of 4⅝ percent on its investment. The lease contained options exercisable by Sunray to renew the lease for two five-year terms at annual rentals equivalent to 2½ percent of the purchase price of the land and for an additional eleven five-year terms at annual rentals equivalent to 1½ percent of the purchase price.

On April 24, 1967, Sunray entered into a second letter agreement with the Trust under the terms of which the Trust agreed to purchase and Sunray agreed to sell approximately 200 additional service station sites at a price equal to Sunray's acquisition costs but not to exceed an aggregate price of eleven million dollars. Sunray again agreed to leaseback the properties for a primary term of 25 years with quarterly rentals sufficient to amortize the Trust's investment in full over such initial term at an interest return of 5⅜ percent with similar renewal options to Sunray as in the first letter; the annual rentals for the first two five-year terms were equivalent to 3 percent of the purchase price, for five additional five-year terms were equivalent to 2½ percent

appraised value and Sunray's actual cost of acquisition, most acquisitions having been made during the preceding 18 months. This also relieved Sunray of the necessity for expensive and time consuming appraisals.

of the purchase price, and for six final five-year terms equaled 2 percent of the purchase price.

Sunray consummated the second letter agreement by conveying 213 separate parcels of land each by separate warranty deed. At or about the same time, Sunray leased the properties for rentals under the terms set out in the letter agreement. Sunray and the Trust executed master leases at each of the closings, the terms of such leases being essentially the same except for effective dates, properties described, and the quarter-annual payments. The leases require that the basic rent be payable absolutely net to the Trust throughout the term *without deduction* or *setoff* and that Sunray, as lessee, pay all taxes, assessments, or similar charges assessed against the premises.

The major provisions of the leases were capsulized by the Tax Court as follows:

> Each lease afforded Sunray an option to purchase any of the leased properties on specified dates, provided Sunray had discontinued or would discontinue the then business use of the property to be purchased. In each instance the price to be paid for the property was to equal its "fair appraised value * * * to Lessor." The appraisal of the property was to be conducted by three appraisers: one chosen by the lessor, one chosen by the lessee, and one chosen by the other two appraisers. The decision of any two appraisers was to be conclusive.
>
> Sunray required that it be able to terminate its obligations to lease any property that might

prove uneconomical to operate as a service station. Each lease was therefore made to provide:

> During the Primary Term of this Lease, Lessee may, if Lessee intends to discontinue or has discontinued the use of the Leased Premises for its then business use, make a rejectable offer to purchase the Leased Premises as of any Basic Rent payment date occurring in the Primary Term at a price in cash equal to the sum of the present values * * * of all quarterly Basic Rent payments to become due on and after the proposed purchase date * * *

plus an amount sufficient to insure the Trust of a return of 5 percent per annum over the term of the investment.

Each lease further provided that if on any one of several specific dates

> * * * Lessee, in the sole exercise of its business judgment, determines that the continued leasing of the Leased Premises has become unprofitable or unreasonable or unnecessary in the conduct of its business use, Lessee may make a rejectable offer to purchase * * *.

Offers to purchase made pursuant to this clause were to be identical to those offers that might have been made by Sunray had it discontinued the then business use of the property.

The Trust was given 30 days in which to consider any rejectable offer that might be made and was nowise obligated to accept such an offer. In the event such an offer were rejected,

however, Sunray would be released from its obligation to lease the property which it had offered to purchase.

Each lease further provided:

> In lieu of making any rejectable offer to purchase the Leased Premises permitted * * * under this Lease, Lessee shall have the right to substitute for the Leased Premises other property (to consist of land only) having a then value at lease equal to the rejectable offer to purchase consideration which otherwise would have been applicable. * * *

(Footnotes deleted.)

As of July 15, 1974, Sunray made over 130 rejectable offers to repurchase properties which it had decided would not be used for business purposes. The Trust accepted each of the offers, reconveyed the properties, and released Sunray from all obligations under the lease.

II.

Relying heavily on *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939), the Commissioner contends that Sunray retained all of the benefits and burdens of ownership to the 320 service station sites it conveyed to the Trust. He maintains that the purported transfer of title and leaseback agreements were, in substance, nothing more than an elaborate financing device in which the Trust stood essentially in the position of a secured lender. The leaseback agreements, the Commissioner asserts, enabled

Sunray to reflect the transactions as a footnote on its balance sheets rather than a liability, minimizing any impact on its credit rating, and, at the same time, enabled Sunray to claim a 100 percent "rental" deduction for its full cost of acquiring non-depreciable land; and that Sunray in fact retained an equity interest in the properties disqualifying the periodic payments under the leases from being deductible under section 162(a) of the Code. The Commissioner asserts that his position is supported by: (1) the "net" lease arrangement, (2) the condemnation and casualty loss provisions of the lease, (3) Sunray's absolute option to repurchase under the terms of the leases; (4) Sunray's unique right to substitute properties in the event its offers were rejected, and (5) "rental" provisions which served simply to return to the Trust the principal sum advanced with fixed interest. Sunray, however, argues that the periodic quarterly payments made pursuant to its agreements with the Trust constituted consideration for the use for business purposes of the service station sites, that the properties were sold for a fair sales price in an arm's length transaction, and that the payments were, therefore, deductible as rentals under section 162(a)(3).

The Tax Court concluded that the terms of the leases did not support the Commissioner's contention that Sunray retained an equity interest in the leased properties after the conveyances. The court believed that the purpose of the provisions for repurchase of the leases was not "to provide Sunray

with the means to reacquire the leased properties," the Trust being under no obligation to accept any offers which might be made, but to insure Sunray's ability to cancel the leases of any property which might prove uneconomical to operate as a service station site. We disagree.

IV.

A threshold problem confronting us is the standard of review. Sunray asserts that the Tax Court based its decision on findings of fact, which included a finding as to the parties' intent, and that these findings are binding upon us unless clearly erroneous. The record in the instant case, however, rests substantially on an undisputed record, consisting principally of stipulations of the underlying facts and appended exhibits, including the leases at issue. The basic rights, duties, and economic interests of the parties are essentially not in dispute. The dispute centers around the characterization for income tax purposes of the letter and lease agreements. The oral testimony offered by each of the parties was either expert testimony interpreting the documents or background testimony of some of the principals pertaining to the negotiations and their views of the transaction. In *ABKCO Industries, Inc.* v. *Commissioner*, 482 F.2d 150, 155 (3d Cir. 1973), we held the "interpretation and construction of a contract is a question of law and that the interpretation by the Tax Court is reviewable by this court." Of course, the subjective intent of the parties may be a consideration in in-

terpreting an agreement where the documents are ambiguous or incomplete and, in such circumstances, the court's determination of the unexplained subjective intent is a finding of fact. When, however, the documents embodying the transaction are clear and complete, the court is called upon to interpret the documents, and from their substance, to characterize the transaction for tax purposes as a matter of law." *Frank Lyon Co.* v. *United States*, 536 F.2d 746, 751 (8th Cir.), *cert. filed*, November 3, 1976, 45 U.S. L.W. 3347. Regardless of whether the parties honestly believe the transaction to be a lease, where the documents they have executed fully embody the elements of their bargain it is the documents themselves, not the parties' conceptions of them, which must govern the legal characterization of the transaction. *See Oesterreich* v. *Commissioner*, 226 F.2d 798, 801-02 (9th Cir. 1955). We view the question here as essentially legal, not factual, and fully reviewable by this court. *Helvering* v. *Lazarus & Co.*, *supra*; *American Realty Trust* v. *United States*, 408 F.2d 1194, 1198 (3d Cir. 1974).

V.

In the usual mortgage transaction between a debtor and creditor, the funds advanced to the debtor are secured by a lien on his property. The debtor agrees to repay the funds over a fixed term together with specified interest for their use; generally, the ownership of property does not change hands. The usual business bargain between a commercial lessor and

lessee is far more complex. Real estate interests between a lessor and lessee normally are divided into a number of parts, each of which represents an ownership interest in property. In order to sort out these interests, the following pragmatic approach has recently been suggested:

> If the characterization for federal income tax law purposes of the interests of a lessor and a lessee is to be determined in a manner consistent with business realities, the inquiry must change from "Who is the owner of the property for tax purposes?" to "Are the ownership interests of lessor and lessee as characterized by the parties consistent with traditional substantive business bargains between lessors and lessees?"

Rosenberg & Weinstein, *Sale-Leasebacks: An Analysis of These Transactions After The Lyon Decision*, 45 J. of Tax, 146, 148 (1976).

In the instant case, the actual conveyance to the Trust of title to the properties and the fair market value of the prices assigned to them does not appear to be an issue. Although Sunray argues that the presence of fair market value as a consideration for the transfer distinguishes the instant case from *Helvering* v. *Lazarus & Co.*, *supra*; and *Leeds & Lippincott Co.* v. *United States*, 276 F.2d 997 (3d Cir. 1960), we doubt that this is a controlling consideration. We deem much more significant the relationships of the parties after the transfer of the properties as a result of the burdens, benefits, and risks imposed on each of

them by the terms and conditions of their lease agreements. In determining whether the sale-leaseback transactions in the instant case created the traditionally bargained for business relationships between owner and lessee or whether Sunray in fact retained an equity in the real estate despite the conveyances, we look to the economic realities of the leases and not to the labels applied by the parties.

In *Lazarus*, *supra*, the taxpayer claimed depreciation on three buildings in which it operated a department store, the legal title to two of which and the assignment of a 99 year lease to the third it had transferred to a bank as trustee for certain land trust-certificate holders. The trustee had at the same time leased all three back to the taxpayer for 99 years with options to renew and purchase. The taxpayer claimed depreciation as a deduction because it bore the capital loss from wear, tear, and exhaustion of the buildings. The Commissioner disallowed the deduction on the ground that the statutory right to depreciation follows legal title. The Court of Tax Appeals, however, allowed the deduction, concluding that the transaction between the taxpayer and the trustee bank was in reality a mortgage loan; that the conveyance of title to the bank was actually given merely as security for a loan and that the "rent" stipulated in the leaseback was intended as a promise to pay an agreed 5 percent interest on the loan. The circuit and Supreme Courts affirmed, the Supreme Court noting that in the field of taxation the courts are "concerned

with substance and realities, and formal written documents are not rigidly binding."

A. The Risks and Responsibilities

As in *Lazarus*, the lease arrangements between the parties in the case *sub judice* provide that the lessee, Sunray, pay all taxes and assume the full burden and cost of keeping the premises in good condition. The Trust is relieved of the responsibility to repair, rebuild, or renew any buildings, structures, or improvements "or to make any expenditures whatsoever in connection with this lease . . . ." Moreover, Sunray has agreed to indemnify the Trust and hold it harmless from any and all liabilities arising from the use and occupancy of the premises, including liability for any causes of action, judgments or violations of laws or regulations affecting the premises. Sunray has also obligated itself to pay rent absolutely net throughout the term without deduction or setoff under any circumstances. Diminution of rental even because of casualty or condemnation is not permitted. Thus, it is apparent that the leases impose essentially all burdens, risks, and responsibilities for the properties upon the lessee. Thrusting all of such burdens and risks on the lessee under every condition and circumstance and none on the lessor is hardly consistent with customary substantive bargains in the market place between lessors and lessees.

B. The Benefits of the Transaction

1. Rejectable offers upon condemnation or seizure by eminent domain.

In addition to assuming the risks and burdens incident to the ownership of property, Sunray also controls certain important benefits which traditionally are reserved to the owner in the event leased premises are condemned or seized by eminent domain. During the primary term, if all or any part of the leased premises becomes "in the sole and absolute judgment of lessee" undesirable for the lessee's business or for any use then existing, because of a taking by condemnation or eminent domain, the lessee has the right to make a "rejectable offer" to purchase the property. The Trust has thirty days after receipt of the written offer to accept or reject it and failure to act within the prescribed period constitutes an acceptance. Significantly, the lessee not only has the unilateral right to determine whether the taking is sufficient to make the premises "undesirable" for its further use, but the repurchase price fixed for the offer is equal to the sum of all present values [4] of the quarterly payments to become due after the proposed date of repurchase,

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[4] Under the leases executed pursuant to the firm letter agreement, the present value of a rent payment is to be determined by discounting it on the basis of an annual interest rate of 4⅝ percent from the date on which it is payable to the date on which the present value is to be determined.

plus a pre-determined premium.[5] If Sunray's offer to repurchase during the primary term is rejected by the Trust, then the condemnation award is payable both to Sunray and the Trust as "their interests may appear" at the time of the taking. During the extended term of the leases, Sunray also has the absolute right to share in any condemnation award as "their interest may appear." Significantly, if a portion of the premises is taken by condemnation or eminent domain but the lessee elects to occupy the balance, there is *no abatement of rent* and the entire award for the taking belongs to the lessee. The lessee is also irrevocably empowered to negotiate the terms and price for any taking and to sell and convey the properties without the prior approval or joinder of the Trust. We view the retention of such broad powers by the lessee in the event of condemnation or government seizure of the land, especially the power to negotiate the price for the land, and the absence of rent abatement in the event of a partial taking and continued occupancy of the balance as inconsistent with the traditional role of a lessee.

2. Rejectable offers upon discontinuance of use.

Sunray also enjoys the unique right when, "in the sole exercise of its business judgment," it decides that the use of a parcel of land is no longer profitable or

[5] The lessee can be relieved of the premium by certifying that it will discontinue the use of the leased premises for any income producing activity.

necessary in conducting its business to make a rejectable offer to purchase it.[6] Again, the price is not dependent upon the fair market value of the land at the time but is fixed in an amount equal to the sum of the present values of all quarterly basic rent payments to become due in the future plus the applicable prepayment premium shown in Schedule "C" attached to the leases.

3. Lessee's rights of substitution.

Sunray also had the extraordinary and absolute right, in lieu of making any rejectable offer or upon acceptance of such an offer, to substitute other land having at least equal value for the leased premises. The value of the land to be substituted "[was to] be determined by the lessee's book value therefor." This unilateral right of substitution thus enabled Sunray to reacquire legal title to any parcel of land whenever it made a rejectable offer.[7]

[6] R. Paul Henry, former senior vice-president for Finance and Planning for Sunray, testified that "we put [this provision] in there in the event the tax law changed and the tax consequences of this deal changed for either party, it permitted the deal to be unwound. But, I know we had some discussion of possible changes in tax law and it was decided it would not be wise to identify that as an occasion for rejectable offer and I think this language [in the leases] was adopted to substitute for that."

[7] Sunray's right to substitute other parcels in the event the Trust accepted a rejectable offer was rescinded by the parties 8 years later, after the commencement of an audit by the Commissioner.

4. Analysis of rejectable offer provisions.

We believe that the substance and reality of the "rejectable offer" provisions, particularly the rights of substitution, enabled Sunray during the taxable years in issue to retain ultimate control over the leased properties subject to repayment with interest of the advances made by the Trust. We cannot accept the Tax Court's conclusion that the rejectable offer provisions do not vest any equity interest in the lessee because "the trust was under no obligation to accept such offers as might be made;" the Tax Court, failed to analyze the lessee's rights of substitution, dismissing them with the observation that they were never exercised and were ultimately rescinded on August 9, 1972, but we believe these rights of substitution rendered illusory the lessor's rights to reject an offer.

The limitations of time, distance, and subject matter also erode whatever substance may have existed in the lessor's rights to reject an offer. The Trust had only thirty days after the receipt of rejectable offers to accept them and the failure to act was deemed to be an acceptance. The offers left the Trust with virtually an impossible task of securing independent appraisals on comparative low unit value properties, securing competent advice, and reaching an intelligent, considered decision within a short time on multiple pieces of diverse properties geographically dispersed over many states. In fact, the Trust initially objected to the thirty-day limitation but ultimately accepted it and agreed to waive an appraisal requirement. Accepting the offer would have required the Trust, having no employees with background or experience in real estate management, to undertake the heavy burden of managing small real estate parcels and properties scattered over 17 states. The acceptance of such a burden was viewed by trust officials as being inconsistent with the investment goals of this 2½ billion dollar trust. Furthermore, since Sunray had to certify that the property would no longer be used for its then existing business purposes, the only time the parcels would be repurchased as a practical matter would be for resale. The extreme impracticality of accepting a rejectable offer is evidenced by the Trust's acceptance of all 136 of Sunray's "rejectable" offers made during the first few years of the leases. The Trust never took possession of any property described in a rejectable offer.

Thus, Sunray, even though it was the titular lessee of the properties, had the exclusive means of realizing the benefits in appreciation in the market value of the properties by making a rejectable offer which had little likelihood of being accepted; if perchance it were accepted, Sunray had the absolute right to substitute other parcels of property. In addition, as we later discuss, Sunray had also the absolute option to repurchase the properties during the extended terms of the leases for an option price equal to the fair appraised value of the leased premises to the lessor.

In our view, the powers vested in the lessee in the event of condemnation or seizure of property pur-

suant to the power of eminent domain, including the right to negotiate the sale or settlement price, the right to make rejectable offers, and the extraordinary rights of substitution are significant benefits characteristic of the ownership of property rather than that of a leasehold.

C. The Rentals

Rentals in these transactions were apparently geared to return the Trust's advances plus interest. To achieve such a result, the rentals for the primary term were set at a predetermined figure. According to R. Paul Henry, who negotiated these transactions for Sunray, the rental value was fixed by formula based on a twenty-five year period to enable the Trust to recover the amount of money advanced for the properties plus "a reasonable agreed amount for what would be comparable to interest. And then, should the leases be terminated prior to the end of the twenty-five year primary term, an added amount would be paid to G.E. [the Trust] because this was a rather awkward type transaction." [8]

Additional evidence in the record indicates that the rentals do not reflect the market value of the properties. We think it significant that the Trust determined the fair rental value for the properties

[8] Mr. Henry acknowledged that in this instance the premium was "the factor applied to bring the effective rate up to either 5 percent or 5¾ percent in the event of premature termination of the leases," and that prepayment penalties arise in mortgage transactions, debenture financing, or private placement loans.

by merely treating the transaction as an "investment alternative," rather than applying the capitalization of earnings method as an accepted appraisal method. Dr. Pope, the Commissioner's expert, prepared a valuation report for the properties which is in the record. It reveals that the rentals fixed for the primary term are quite high.[9] A fair rental value for a non-wasting asset such as unimproved land to a lessee with Sunray's high credit standing would be the cost of money times the investment. Dr. Pope's valuation report reveals that in October 1964, Government bonds were yielding 4.15 percent, triple A utility bonds were paying 4 3/8 percent, and top grade corporate bonds were paying 4.52 percent. Effective mortgage rates ranged from 5.5 percent to 6.1 percent, depending upon the lending institution. Although the annual rate of return due under the transactions with the Trust was 6.79 percent, Dr. Pope revealed that a reasonable rate of return would have been 4⅝ percent, the interest rate specified in the lease agreement, without the amortization of the cost of the land. The amortization of unimproved land as part of the rental, represented by the difference of 2.144 percent, is not a common practice in the marketplace. In short, the rentals were mathematically geared to amortize the

[9] The Tax Court in the instant case did not make any findings of fact or conclusions of law regarding the reasonableness of the rent payable by Sunray during either the primary or extended terms of the lease. *Compare* Leslie Co. v. CIR, 539 F.2d 943 (3d Cir. 1976), in which we relied on the Tax Court's findings as to the fair rental value of the leasehold.

moneys advanced by the Trust at the agreed annual rate of 4⅝ percent over the primary 25 year term of the lease or through the exercise of Sunray's repurchase rights; they bear little resemblance to the true economic value of the properties.

Also supporting the Commissioner's contention that the rentals do not reflect market value but were merely based on a formula which included the current interest rate plus an amortization factor is the underlying "Schedule of Direct Reduction Loan" attached to the leases which sets forth in typical loan arrangement form the interest rate, the amount of the principal loan, the term of years, the payment number and the apportionment of the quarterly payments between principal and interest. This schedule of payments is identical to the procedures utilized in conventional direct reduction mortgage loans which became popular in this country during the "Great Depression" of the 1930's. Likewise, in their negotiations, the parties frequently referred to the payment of interest and principal, to "standby fees" and loan "commitment fees," terms common in mortgage financing and not in the traditional relationships between lessor and lessee.[10]

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[10] In his lengthy letter dated September 21, 1964, to Eastman Dillon, chief counsel for Sunray understood the essence of the transaction as a loan. He wrote: "A money lender who is being offered at least a return of the principal together with 5 percent interest thereon should have no reason to insist on an appraisal." Another paragraph of the same letter refers to the unacceptability of the Trust's proposal because of its adverse effects on "the *economics* of the *financing*." (Emphasis supplied.)

In the letter dated September 21, 1974, to Eastman Dillon, Sunray's counsel also points out that in the twenty-sixth year of the proposed lease, "the unencumbered appraised value would probably exceed the original investment if present inflationary trends continue." Notwithstanding his conception of the increased value in the land and his prophetic view of inflationary trends, the rentals payable in the twenty-sixth year and thereafter during the next sixty-four years of the thirteen extended terms do not increase but are sharply reduced. The quarter annual rents drop from $1015.38 to $375.00 for the first two extended terms and then drop again to $225.00 for the next eleven extended terms. Thus, Sunray having paid for the properties in full during the primary term, was entitled to remain in possession for the next sixty-five years at nominal rents. If it exercised all of its options for each of the extended terms, the additional cost therefor, as the Tax Court recognized,[11] was merely to increase the Trust's return from 4⅝ percent per annum to 5½ percent. It is hardly conceivable that an owner of real estate—especially a large sophisticated trust—concerned with a fair rental on its land rather than a return of its loan and interest, would enter into a lease with sharply declining rentals for sixty-five years following the conclusion of the primary term on December 31, 1989. The

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[11] The Tax Court stated that "[i]f Sunray were to exercise all the options to renew, the Trust would realize a return of approximately 5½ percent per annum on its investment over the terms of the lease as extended."

extended term features of the lease further indicate to us that the Trust, as a lender, was only looking to a return at a fixed rate on its advances, and not to a reasonable return on the fair market value of property which it held as owner.

D. The Options to Repurchase

The repurchase provisions of a sale and leaseback agreement serve the same function as a mortgage loan when the repurchase price is geared to the unamortized principal advanced by the purchaser-lessor. *See Frank Lyon Co., supra,* 536 F.2d at 752-54. In the instant case, in addition to Sunray's right to make rejectable offers to repurchase the parcels in certain situations by, in effect, paying off the unpaid principal balance of the Trust's advance plus the applicable schedule "C" premium payment, Sunray has the absolute right to purchase leased parcels under section 9 of the leases during the first year of each of the thirteen extended terms. This right is subject to the same conditions stipulated in connection with the rejectable offers: (1) that Sunray must discontinue the use of the premises "for its then business use" and (2) that the repurchase price be equal to the "fair appraised value of the leased premises to Lessor" as fixed by three appraisers. These provisions give Sunray considerable flexibility despite the requirement that it must discontinue "its then business use" of the property. Since most of the sites were unimproved non-income properties at the time

of the lease arrangements, Sunray could improve the properties and resell them to investors whenever it deemed conditions appropriate in the future, as it previously had done on other occasions with similar properties, and such a sale would work a change in the "then business use." Furthermore, nothing prevented Sunray from diversifying its operations and using the land for other income producing purposes.

The Commissioner contends that the appraisal procedure prescribed for these non-rejectable obtions gives Sunray another avenue by which to enjoy appreciation and the "equity" built up through its "rental" payments. The contract provides that upon exercise of the option, the lessor and lessee will each appoint an appraiser and the two appraisers thus chosen will select a third. The appraisers are required by majority decision to fix "the fair appraisal value of the leased premises to the Lessor" and the appraisal fees and expenses are to be paid solely by the lessee. The Tax Court disagreed with the Commissioner's analysis of this provision, reasoning:

> Respondent [Commissioner] maintains that the price established by this formula would be the appraised value of the property as encumbered by the Sunray leases—an amount equated by respondent with the present value of future rentals. Thus understood, the provision establishing the option price would preclude the Trust from enjoying appreciation in the value of the

property subsequent to the conveyance by Sunray. In our opinion, however, the formula, based as it is upon an appraisal of the property, would secure to the Trust the benefit of such appreciation.

We believe the Tax Court misconstrued the provisions when it read them as requiring the lessee to pay the fair market value for the property upon the exercise of the options. In the absence of a provision to the contrary, the appraisers had to consider all legal obligations encumbering the property in appraising its value and had to recognize the present value of any reversion in the land at the termination of the encumberance. *Plaza Hotel Assn.* v. *Wellington Assn.*, 55 N.Y. Misc. 2d 483, 285 N.Y.S. 2d 941 (Sup. Ct. 1967); *aff'd* 28 App. Div. 2d 1209, 285 N.Y.S. 2d 267 (1967), *aff'd*, 22 N.Y. 2d 846, 239 N.E. 2d 736 (1968). Counsel for Sunray recognized that the leases encumbered the properties and adversely affected their appraisal after the primary term.[12] Thus, in assessing the "fair appraised value . . . to Lessor," the appraisers would have to consider the encumberances of the properties with leases of

[12] This view is reflected in his letter of September 21, 1964, to Eastman Dillon wherein he writes: "Since, as of the time of the exercise of the option, the land is still burdened with the Lease, the repurchase price is essentially the then present value of future rents under the Lease. . . . Because of the low extended term lease rents (2.5% per annum of the original investment for 10 years, and 1.5% per annum for the remaining 55 years) the unencumbered appraised value would almost certainly be higher than the encumbered appraised value."

very low rentals, thereby seriously reducing the present value of future rentals.

The Commissioner also contends that since the option price was equal to the present value of future rents payable under the lease the appraisers must recognize that the reversionary value of the property in the year 2055 is de minimis because of the high discount factor applicable to a sum due sixty-five years in the future. If the fair market value had doubled or quadrupled, Sunray would be able to acquire the property for a fraction of its original cost.[13] Sunray argues, on the other hand, that the lease agreements are not totally clear, and that the Commissioner's interpretation conflicts with the language of the lease, with the interpretation of his own expert, and with that of the trustees of the Trust. Sunray asserts that the Tax Court appropriately found that the option price was not merely equivalent to the present value of future rents but that it would secure to the Trust, upon appraisal, the benefit of any appreciation in value of the properties.

Our review of this holding by the Tax Court is not limited to the clearly erroneous rule, as Sunray argues, since the interpretation of the option provisions is a question of law. We disagree with the

[13] Dr. Pope illustrated this point with the following example. Assuming a property cost $60,000 at the outset of the sale in 1965 and it had a market value of $100,000 in 1990. Given a 6 percent factor, Sunray could repurchase the property for about $21,000.

Tax Court's view of these provisions of the leases for the reasons previously expressed and hold that the "then appraised value" to the lessor is essentially equivalent to the present value of the future rents under the lease. Th is, the options to repurchase provide Sunray with a built in latch-string by which it could spring legal title to the properties whenever it served its convenience without obligating Sunray to pay the fair market value. Sunray could thereby acquire the benefits of appreciation in the property by merely paying the present value of future rents payable under the lease.

Finally, Sunray contends that the Trust may, without notice to or consent of Sunray, assign or transfer to any party, for any purpose, at any time its rights under the lease, even for purposes of refinancing. It argues that the Trust's ability to refinance its investment is a significant attribute of real estate ownership. This may be true as a general principle. In the instant case, however, the right to assign or refinance may be hollow since it is subject to the extraordinary low rentals during the lengthy extended terms of the leases. Furthermore, any significance attached to the right to refinance is eroded in the instant case by other significant attributes of ownership retained by the lessee.

VI.

In conclusion, we recognize that sale-leaseback arrangements play a useful and accepted role in our

economy. We also note that some of the provisions of the leases in the instant case when viewed independently do not brand the transaction as a financing arrangement. A number of other important features, however, "have been employed in the same transaction with the cumulative effect of depriving [the lessor] of any significant ownership interest." *Frank Lyon Company* v. *United States*, *supra*, 536 F.2d at 754.

As the lessee, Sunray bore the burdens, risks, and responsibilities for the properties, including the obligation to provide the Trust with a fixed guaranteed return under all circumstances and conditions. The lessee also controlled important benefits traditionally reserved to the owner of property: the lessee had the right to negotiate the settlement or accept the condemnation award and receive the payment; in the event of total or partial condemnation the lessee retained the right to terminate the lease whenever in its sole judgment a parcel of land was no longer profitable or necessary in its business and to make a "rejectable offer" which for all practical purposes was unrejectable; the lessee, in any event, enjoyed the right to substitute other land if perchance an offer was accepted or in substitution of a rejectable offer. These risks, burdens, and benefits are strong attributes of ownership, not of a leasehold interest.

The leases also bear marked similarities to debt financing, particularly to direct reduction loans, including the structural and guaranteed interest rate, consisten' with the going market interest rate for

quality firms of Sunray's credit standing, the prepayment penalties, the schedule of payments, and the rejectable offer procedures. The rents have no visible connection with the economic value of the property but are evidently related to a fixed interest return on the advances. Finally, the options to acquire the property at the end of the primary term at the value to the lessor is a form of "equity" because the value to lessor is really the present value of future payments for sixty-years at a specified rate.

We therefore conclude that the sale-leaseback transactions were a financing arrangement. Sunray's claim under section 162(a)(3) for rental payments made pursuant to the leases will accordingly be disallowed.

The decision of the Tax Court will be reversed and the case remanded for the entry of an appropriate decision not inconsistent with this opinion.

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v.

THE UNITED STATES, *Respondent*.

On a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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REPLY BRIEF FOR THE PETITIONER

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TABLE OF CONTENTS

Page

REPLY

I. *Helvering* v. *F. & R. Lazarus & Co.* 1

II. The Government's Argument That This Case Properly Presents Only Questions of the Construction of Written Instruments is Unsound 6

III. There Is No Basis In the Record or Precedent for Treatment of the Transaction as a Sham, or of Lyon as an Accommodation Party 11

IV. The Government's Unsupported Factual Assertions About Option Prices and Rentals Are Contradicted by the Record, the District Court Decision, and the Precedent Upon Which the Government Relies 18

CONCLUSION 23

TABLE OF CASES AND AUTHORITIES

CASES:

American National Bank of Austin v. *United States*, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819 ..... 4, 10

Commissioner v. *Brown*, 380 U.S. 563 (1965) 2, 3

Estate of Franklin v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976) 3, 11, 20

Frenzel v. *Commissioner*, 1963 P-H Memo TC, ¶ 63, 276 (October 7, 1963) 21

Helvering v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939) 1-6

Holbrook v. *Commissioner*, 450 F.2d 134 (5th Cir. 1971) 12, 13

Midler Court Realty, Inc. v. *Commissioner*, 521 F.2d 767 (3rd Cir. 1975) 19, 21

Mt. Mansfield Television, Inc. v. *United States*, 239 F.Supp. 539 (D. Vt. 1964), affirmed, 342 F.2d 994 (2nd Cir. 1965), cert. denied, 382 U.S. 818 21

Nelson v. *Commissioner*, 281 F.2d 1 (5th Cir. 1960) .. 13

Page

Starr's Estate v. *Commissioner*, 274 F.2d 294 (9th Cir. 1959) 21

Union Planters National Bank of Memphis v. *United States*, 426 F.2d 115 (6th Cir. 1970), cert. denied, 400 U.S. 827 .....4, 10, 16

United States Fidelity & Guaranty Co. v. *Commissioner*, 40 B.T.A. 1010 (1939) 13

STATUTES:

Internal Revenue Code, § 48(d) 7

MISCELLANEOUS:

FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976) . 18

Rev. Proc. 75-21, 1975-1 Cum. Bull. 715 .....18, 25

Rosenberg and Weinstein, *Sale-leasebacks: An analysis of these transactions after the* Lyon *decision*, 45 Journal of Taxation 146 (September 1976) .. 25

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The Government contends that tax substance is a legal matter suitable for de novo determination by a court of appeals, yet its brief presents an extended argument based almost exclusively on factual inferences from the evidence. Since the Government has raised so many factual issues, we have found no alternative except to reply to them in detail.

I.

HELVERING v. F. & R. LAZARUS & CO.

The Government rests its case very largely on *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939), without recognizing that its argument here is essentially the one which the Court rejected in the *Lazarus* decision. The *Lazarus* case was a two-party case, involving an *owner* and a *finance* agency. The Court held that the finance agency held title simply as security for its loans, and thus had no depreciable interest in the

property. This was directly contrary to the contention of the Government in *Lazarus,* which there contended that "the statutory right to depreciation follows legal title." 308 U.S. at 253.

In the present case, however, there are three parties to the real estate transaction—the *owner* (the petitioner here), the *tenant* (Worthen bank), and the *finance* agencies (First National City Bank, and New York Life). The *Lazarus* decision does hold that the finance agencies are not entitled to deduct depreciation; but it decides nothing whatever as between the *owner* and the *tenant*. Here the petitioner made an investment in the property; it undertook obligations with respect to it. It had a whole congeries of rights in the property, some present and immediate, and others extending over a long period of years, and dependant on events as they might occur in the future.

That the petitioner financed part of its permanent investment through loans from New York Life, and that it expected to be able to repay these loans from rents to be paid by the tenant, is hardly relevant. That is true with respect to the owner-investor in almost every large real estate construction transaction. The *owner* does not have all the money required, so he borrows some or all of it from a *finance* agency on the security of the structure; and then, in order to repay his loan he enters into a lease with a *tenant*, expecting that the rentals will meet his loan obligations. The fact that he borrows, or that he rents, does not make the owner any less an owner entitled to deduct depreciation and interest, though he necessarily gives up a considerable portion of his "bundle of interests" to the finance agency and to the tenant. The fact that the rent money is used to pay off the financing obligation does not make the owner a "conduit". (Govt. Br. 53.) See *Commissioner* v. *Brown,* 380 U.S. 563 (1965). Where the owner makes his own investment in the property, assumes and meets the finance obligations, and has substantial, though uncertain, interests in the future, he is the owner of the property, entitled to depreciation, and nothing decided in *Lazarus* indicates the contrary.

The Government continues to slight the issues which *Lazarus* identified as central to the right to take depreciation—the intent of the parties, the burden of depreciation and obsolesence of the asset, and the findings of the trier of fact.

A. Even where lip service is given to the burden of depreciation (a 2-page treatment begins at page 56 of the Government's 71-page brief), the conclusion reached is that Worthen "will enjoy the *benefits* of the building over its entire economic life." (Govt. Br. 57; emphasis supplied.) This not only misstates the situation substantially, it focuses on the wrong issues—the benefits to Worthen and the asserted "ceiling" on Lyon's return. This sort of reasoning is relied on again and again. Govt. Br. 26, 31, 38, 41, 57, 62. But as the court admonished in *Estate of Franklin* v. *Commissioner,* 544 F.2d 1045, 1049 (9th Cir. 1976):

> Bad bargains from the buyer's point of view—as well as sensible bargains from buyer's, but exceptionally good from the seller's point of view—do not thereby cease to be sales. *See Commissioner* v. *Brown,* 380 U.S. 563 (1965); *Union Bank* v. *United States,* 285 F.2d 126, 128, 152 Ct.Cl. 126 (1961).

From the viewpoint of the purpose of the depreciation deduction, this insistence on Worthen's benefits actually undermines the Government's position. It is Worthen rather than Lyon which is largely insulated

from risks occasioned by diminution in value; and it is Worthen therefore which is in a position similar to the banks whose ownership was disregarded for tax purposes in the cases relied on by the Government—*Union Planters National Bank of Memphis* v. *United States*, 426 F.2d 115, 117-118 (6th Cir. 1970), cert. denied, 400 U.S. 827, and *American National Bank of Austin* v. *United States*, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819. Worthen will never be obliged to pay more than fair rentals, and it has available an option price which the Government contends is low.[1] Lyon can of course insist upon Worthen's upkeep obligations (which exclude reasonable wear and tear), but these conditions are an ordinary aspect of the net lease.

B. Seemingly, the Government relies on Worthen's benefits because these are clearer in the documents on which the Government totally depends. The risks of the transaction and the frangibility of the asset will only be made certain by the course of events, and such factors do not fit well into the Government's rigid conceptual universe of common law ownership, and factual predictions presented as legal conclusions.

This Court took a very different approach to determining "tax substance" in the *Lazarus* case, upon

[1] In its statement of the question presented, Govt. Br. 2 (and throughout its brief), the Government erroneously asserts that the lessee had an option to acquire title to the building "for an amount that was unrelated to its fair market value." This statement is in flat contradiction with the findings of the district court and the facts of record. Though computed in terms of a 6% compounded return on $500,000 plus the assumption of the unpaid balance of the New York Life mortgage, this was the parties' attempt to arrive at a fair market value of the property and is a method commonly used in sale and leaseback transactions (I App. at 127, 228, 234, 240-241).

which the Government relies so heavily. Instead of dogmatically asserting what the facts were, as the Government does here, the *Lazarus* Court assessed the situation as it presented itself to the parties in order to determine the substance of the transaction.

The Board of Tax Appeals and the Court of Appeals for the Sixth Circuit had held that the deed to the bank, though absolute in form, was in reality intended by the parties as a mortgage to secure a loan. Both the taxpayer and the bank testified that they intended the transaction as a long-term loan secured by the real estate. The taxpayer further testified that it was not interested in selling its property, that it would not have sold for $3,250,000 property worth $6,000,000, and that the annual rentals established to service the loans were less than the fair rental value of the property. This Court said, 308 U.S. at 254-55 (emphasis added):

> "... The Board in substantial effect found that the instrument under which the taxpayer purported to convey legal ownership to the trustee bank *was in reality given and accepted* as no more than security for a loan on the property; the 'rent' stipulated in the concurrently executed ninety-nine year 'lease' back *was intended* as a promise to pay an agreed five percent interest on the loan; and the 'depreciation fund' required by the 'lease' *was intended* as an amortization fund, designed to pay off the loan in forty-eight and one-half years. *These findings are supported by evidence* which permits, at most, conflicting inferences *and are*, therefore, *conclusive here*. And, unless the Board committed error of law we must affirm."

C. In the present case the evidence indicates and the trier of fact found that option prices and rentals were reasonable estimates of market values, that the trans-

action was a bona fide sale and so intended by the parties, and that risks of depreciation are borne by Lyon—both in the decreasing option prices and rentals as the building ages, and the risk that the building will depreciate in value below the option prices and rentals. The situation is fundamentally different from that presented in *Lazarus* since the question here is not between the owner and the finance agency, but is between the owner and the tenant, and the findings of the trier of facts which this Court said in *Lazarus* are "conclusive here" clearly support the taxpayer. Thus *Lazarus* supports Lyon, not the Government.

II.

THE GOVERNMENT'S ARGUMENT THAT THIS CASE PROPERLY PRESENTS ONLY QUESTIONS OF THE CONSTRUCTION OF WRITTEN INSTRUMENTS IS UNSOUND

Although the Government says that its conclusions in this matter are based solely on interpretation of the documents and legal conclusions drawn therefrom, every crucial point of its argument depends on factual predictions and judgments. The Government asserts that the option prices were "nominal" and that there is no "realistic way" in which Lyon can benefit from the arrangement. Govt. Br. 29. Various factual contentions raised by the Petitioner are said to be "highly unlikely" or "highly improbable". *Id.* at 31, 34, and 38. It attempts to evade the findings of the district court on the issue of the relationship between options or renewal rentals and fair market value by saying that there was no evidence on this point (*id.* at 45), when in fact it seeks to controvert the evidence offered by the parties, and by the independent realty consultant, and accepted by the district court.

Even aside from the fact that there is no way that these assertions could have been drawn from interpretation of the documents, they are effectively undercut by three points.

1. The Government never introduced any evidence whatever on fair and reasonable market and rental values. The petitioner did produce such evidence and the district court credited it fully. What the Government now argues is either that the district court made some factual misinterpretation of the record or that rentals are never fair if they equal amortization expenses plus an agreed return on equity. See n. 1, *supra*.

2. While presenting its predictions and real estate assessments as inevitable legal conclusions drawn from the documents, the Government fails to point out the fact that its predictions and assessments have changed continuously in its attempt to fit the transaction into the neat categories provided by the traditional common law. At trial the Government focused on the low initial ground rents (now conceded to be a wash), and the asserted inevitability of the exercise of the eleventh year option because that was the period when the tax benefit would be greatest (an event now conceded to be unlikely). Between the court of appeals and this Court, the Government has abandoned two factors which were persuasive to the court of appeals: allocation of the investment credit to Worthen (a tax benefit which is by statute freely allocable between the parties, I.R.C. § 48(d)); and the assertion that Lyon could not sell the building to third parties. (There is no prohibition of Lyon's selling the building and Lyon has had opportunities to sell at a profit, which it has declined in order to hold on to the investment. I App. 261-62; P. Ex. 51, II App. 687.)

Moreover, the Government has added a new point which it totally ignored below, allegedly "bargain" renewal rentals. According to the opinion of the district court below, the Government did not even contest the matter of reasonableness of the renewal rents, Pet. App. 6a, though it has now been translated—without benefit of evidentiary support or prior consideration—into the decisive factor. See Section IV, A, *infra*.[2]

[2] On pp. 19-20 of its brief, the Government states that the Court of Appeals' decision was based on six findings of fact, and in its subsequent arguments the Government relies heavily upon these "facts". Examination of the facts reveals that the Court of Appeals was in error in each of these "findings" on which its opinion was based.

(1) The lease agreement "circumscribed petitioner's right to profit from its investment in the building" by giving Worthen the options to purchase for $500,000 plus 6% compounded interest and the assumption of the unpaid balance of the New York Life mortgage. This is untrue for the following reasons: (a) Frank Lyon Company had the right, and many opportunities, to sell the building at a greater profit at any time (I App. 261-62; II App. 687, P. Ex. 51); (b) the 6% return compounded annually cannot be said as a matter of law to be too insubstantial to be attractive to a true investor in real estate; (c) the 6% return compounded annually was the *minimum* return petitioner would realize if Worthen exercised one of its options (I App. 162-63), an event the district court found to be highly unlikely; and (d) petitioner would own the building and realize a much greater return than 6% if Worthen did not exercise an option to purchase (I App. 34-36, 50-53). See pp. 16, 23, *infra*.

(2) "[T]he option prices did not take into account possible appreciation of the value of the building or inflation." Govt. Br. 20. To the contrary, the district court found the option prices to be the negotiated estimate of the parties of the fair market value of the building on the option dates and to be reasonable (I App. 303). Such estimates would necessarily have considered appreciation and inflation as well as depreciation and obsolescence; the Court of Appeals seems to have confused the value of the land, which is not likely to depreciate, with the value of the building, which is. See Pet. Br. at 26-34.

(3) "[A]ny award realized as a result of the destruction or condemnation of the building in excess of the mortgage balance and petitioner's $500,000 investment would be paid to Worthen and not petitioner." Govt. Br. 20. This was true only with respect to *total* destruction or taking of the building *after December 1, 1980*. Petitioner, not Worthen, would receive the excess above the mortgage balance in the event of *total* destruction or taking *before December 1, 1980* or in the event of *partial* damage or taking *at any time* (I App. 408-10; 411).

(4) While it is true that "the building rental payments during the 25-year primary term were exactly equal to the mortgage payments", Govt. Br. 20, this does not justify the conclusion that "petitioner merely served as a conduit by which the mortgage payments would be transmitted to New York Life." Govt. Br. 20. This ignores the fact that petitioner was the sole obligor on the New York Life note and would remain liable in the event of default by Worthen. The fact that the rent was sufficient to amortize the loan during the primary term of the lease was a requirement of New York Life, and is a usual requirement in most long-term loans secured by a long-term lease (Pet. App. 12a). The absence of a pretax cash flow is not unusual in many real estate investments (I App. 235). Testimony proved and the district court found that the rents during the primary term were reasonable and represented the fair rental value of the building, a fact not contested by the Government. (I App. 236, Pet. App. 6a).

(5) Worthen did not "retain control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the underlying land." Govt. Br. 20. The Court of Appeals here ignored (a) petitioner's right to sell the building to another investor at any time; (b) the lower court's finding that the options to purchase would not likely be exercised, (c) the uncertainty that Worthen would renew the lease for 40 years, see pp. 22-23, *infra*, (d) petitioner's right to lease to anyone at any price during the last 10 years of the ground lease, and (e) petitioner's continuing ownership of the building after the expiration of the ground lease, see pp. 15-16, *infra*.

(6) "Worthen enjoyed all of the benefits and bore all the burdens incident to the operation and ownership of the building so that the only economic advantage accruing to petitioner . . . were income tax savings of $1.5 million during the first 11 years of the arrange-

3. The cases on which the Government relies are inadequate to support its position here. In the cases dealing with bond transactions between banks and dealers,

the "objective economic substance" of the transactions could be readily determined from their short duration, the limited range of possible outcomes, and the fact that the results which occurred fell into a repeated and predictable pattern. *American National Bank of Austin* v. *United States,* 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States,* 426 F.2d 115, 117-18 (6th Cir. 1970), cert. denied, 400 U.S. 827. Not only were the terms of the arrangement undisputed, the factual results were as well. The banks were protected from any loss whatever, and there was never any refusal to resell to the dealers in the history of the arrangements. It was the dealer who bore the risk of market fluctuations. See 426 F.2d at 118.

In the present case, by contrast, the practical results of the carefully planned arrangement into which Lyon and Worthen have entered depends on a number of future events, including future market values, the future situation of the parties, and the future of the banking business and the real estate market in Little Rock. As even the Government states in a veiled concession, "petitioner did not . . . stand to suffer from any decrease in [the building's] value (unless the value fell below the option price) . . ." (Govt. Br. 23.) As Lyon has indicated in its brief, pages 26-34, and *infra* at pages 22-

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ment." Govt. Br. 20. As the district court found, the benefits of occupancy which Worthen will enjoy are quite common in most long-term real estate leases (I App. 309-10). The district court also found that petitioner had motives other than tax-savings in entering into the transaction, i.e., a need to diversify its holdings, a need to use its accumulated earnings, and the long-term return it could expect when the mortgage indebtedness was retired (I App. 298, 308-09). Finally, the net cash after-tax benefit would be $312,220, not $1.5 million. (I App. 273, D; Ex. 6 at II App. 696).

23, this concession understates the risk to Lyon. But this qualification on the Government's present factual position, along with its vacillation on the prospects of the arrangement, makes it clear that factual inferences and predictions in the instant transaction present considerable elements of doubt and risk. Compare also *Estate of Franklin* v. *Commissioner,* 544 F.2d 1045, 1049 (9th Cir. 1976).

The crucial questions here are questions of factual inference and prediction, and it is determination of these questions which is necessary to arrive at the "substance" of the transaction. The Government badly misrepresents the findings and holding of the district court below when it indicates that its holding was based entirely on a finding of subjective intent or deference to "labels". Govt. Br. 25. The court upheld the contentions of the taxpayer based upon findings as to "'objective'" as well as "'subjective'" intent, and upon the conclusion that "the transaction was in substance, as well as form, a sale-leaseback with option to repurchase" and not a mere financing or tax avoidance scheme. Pet. App. 2a.

III.

THERE IS NO BASIS IN THE RECORD OR PRECEDENT FOR TREATMENT OF THE TRANSACTION AS A SHAM, OR OF LYON AS AN ACCOMMODATION PARTY.

A. The Government has never denied the separate existence and motives of the parties, has never disputed directly the existence of substantial nontax motives, and has never maintained that relations, or some sort of side agreement between the parties, would indicate that this transaction was in any way a sham or not bona fide.

The Government now, however, produces the contention that the bargaining was not "arms-length" in nature because the parties are to be mutually advantaged by the transaction and a part of the advantage relates to tax treatment. Govt. Br. 62-65. In *Holbrook* v. *Commissioner*, 450 F.2d 134 (5th Cir. 1971), cited in Govt. Br. 36, the Fifth Circuit effectively rejected the sort of reasoning the Government has used here (450 F.2d at 142-53):

> "Surely it cannot be inferred solely from the fact that a tax advantage will be reaped from it that the subrogation right was given for tax reasons only and was without substance. Without proof that the debtor in such cases was controlled by the taxpayer, or in some other condition or circumstance indicating a lack of substance to the taxpayer's right of subrogation, we do not think the Tax Court is as liberty to so find. Credit purchases and the granting of subrogation rights, like sales, are commonplace in our economic system. They are so ordinary that we are not willing to presume them to be shams or lacking in economic reality without affirmative proof. We instead presume ordinary contract rights to have value in the absence of contrary proof."

"Adverseness" or arms-length bargaining need not be based on total hostility. It was the clear import of the holding of the court below (Pet. App. 2a, 6a, 11a), and the testimony of the parties as well as the representative of New York Life, that the bargaining was thorough and strenuous:

> "Well there was just considerable give and take, bargaining, negotiating among the parties. I assume these documents are in evidence. There were volumes of documents and were negotiated chapter and verse, paragraph by paragraph, almost word for word." I App. 85-86. (Testimony of New York Life representative).

The cases which the Government cites for its characterization of Lyon as an "accommodation party" in the arrangement illustrate the bankruptcy of the Government's position on this point. Govt. Br. 55, and n. 37, citing *Nelson* v. *Commissioner*, 281 F.2d 1 (5th Cir. 1960); *United States Fidelity & Guaranty Co.* v. *Commissioner*, 40 B.T.A. 1010 (1939). First, both cases involved determination of tax consequences as between a wholly-owned subsidiary and its parent or owner. The relationship is in no way comparable to that presented here. Second, in treating the wholly-owned subsidiary as a conduit, the *Fidelity & Guaranty* court made it clear that there was no conceivable way in which the "accommodation party," the subsidiary, could profit from the transaction. Even the Government concedes some nontax benefits will accrue to the Lyon Corporation. Third, the *Nelson* court ultimately denied the taxpayer's attempt to ignore the corporate entity of its subsidiary because it found that the corporation had an independent existence and was not a sham entity. 281 F.2d at 6. There is, of course, even more basis in this instance to recognize and affirm the distinction between the entities and interests in this case. See also *Holbrook* v. *Commissioner, supra.*[3]

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[3] In consenting to petitioner's assignment of the building lease to New York Life, Worthen did agree to pay the rent directly to New York Life. Govt. Br. 35-36. However, this provision, for the protection of New York Life in the event of a default by petitioner in the payment of its note to New York Life, has never been required by New York Life. Worthen has in fact paid its rent *monthly* to petitioner, which rent has been deposited in petitioner's regular checking account. Petitioner has in turn met the *quarterly* payments on its note to New York Life by sending New York Life a check drawn on petitioner's bank account (I App. 77-78).

B. The Government cites the fact that Lyon accepted Worthen's proposal without trying to get any more favorable terms. Govt. Br. 62-63. But (1) Lyon thought it had to lower its bid to get the building because of the other investors (I App. 112-13; Pet. App. 10a); (2) Mr. Barnes and Mr. Lyon testified that the building could easily be sold under the lease to a third party (I App. 242, 261-62); and (3) Lyon was only accepting the broad proposal, it could and did attempt to get more in actual negotiation.

The conclusion that Worthen dictated all the terms or that Lyon retained no interest is simply untenable. *See, e.g.*, I App. 31, 32, 46, 86. The Government states "that Worthen's president testified that petitioner had 'nothing whatsoever to do' with determining the substantive provisions of the contract." Govt. Br. 62. This quotation is lifted from context in a misleading way. Edward Penick testified that the "format of a sale-leaseback" transaction was dictated by the bank regulatory authorities prior to petitioner's interest in the transaction, so that petitioner had "nothing whatsoever to do" with the "form of the arrangement" (I App. 155), not, as the Government loosely asserts, "the substantive provisions of the contract."

The basic terms, rather than being "dictated by Worthen", were the result of proposals by potential investors, including petitioner, in a highly competitive situation. Rather than share the investment with Stephens, Inc. as suggested by Worthen and anxious to be the low bidder, petitioner submitted a counterproposal reducing the rent $21,000 per year for the first five years (I App. 25, 27-28).

After petitioner had been selected by Worthen as the owner, based upon petitioner's low bid on the above

basic terms of the transaction, petitioner negotiated with Worthen, New York Life and First National City Bank in hard arms-length bargaining for six months over innumerable terms of the various agreements (I App. 29, 39, 85, 86, 150). It was during this period, for example, that petitioner bargained for and obtained from Worthen an extension of the ground lease for a period of 10 years beyond the building lease at a rental of only $10,000 per year (I App. 35-37), and bargained for and obtained Worthen's various indemnity and hold harmless clauses to protect petitioner against losses (I App. 95-105).

C. In attempting to negate any feature of the transaction which is inconsistent with its picture of Lyon as a straw man, the Government is driven to inconsistent and confusing statements about two of the most obvious aspects of Lyon's ownership of the building: its unencumbered ownership of the building after the end of the lease with the concomitant rights during (1) the last ten years of the ground lease, and (2) the period after the end of the ground lease.

The principal confusion stems from the contention that Lyon will have no rights whatever in the building once the term of the ground lease is up. The Government's contention seems to be that Lyon cannot maintain that it has rights as the owner of the building under Arkansas law if Lyon is not the owner of the building for Federal tax purposes. Govt. Br. 42, n. 27. This is an obvious non sequitur.

The district court held that Lyon was the owner of the building under Arkansas law (I App. 291; Pet. App. 3a) and the Government has not contested that conclusion prior to this point. Petitioner's brief sets

forth at length the understanding and agreements of the parties on ownership and points out the specific omission of any right of reversion in Worthen. Pet. Br. 41-44. Even if it were to be concluded that Lyon is not the owner for Federal tax purposes, this should not change the property rights of the parties inter sese. As the reasoning of the court in *Union Planters National Bank of Memphis* v. *United States*, 426 F.2d 115, 117 (6th Cir. 1970; McCree, J.), cert. denied, 400 U.S. 827, indicated, even if the intent of the parties is not controlling for Federal tax characterization purposes, it is still crucial to their rights inter sese. The Government has not advanced any reason why Federal tax law should control rights between the parties, or consequences under Arkansas property law.

The Government also argues that "equity" would preclude Lyon from receiving any equitable adjustment for the building because the parties agreed that Lyon's return was to be six percent, and an adjustment might raise its overall return above this figure. Govt. Br. 41-42, n. 27. This is a clear example of result-oriented thinking on the part of the Government. It has extrapolated the six percent figure from its calculations based on the rentals and options, but there is no indication whatever in the agreements between the parties or elsewhere in the evidence that the resulting number has independent significance as a ceiling upon any return by Lyon, however achieved. On the contrary, the record indicates that Lyon relied on and bargained for the rights in question, see, e.g., I App. 35-37, and has always expected greater return than six percent. See n. 2, *supra*.

D. The Government shows, in successive footnotes, a similar confusion on the period between the end of

the building lease and the end of the ground lease. Govt. Br. 39-40, nn. 25 and 26. On the one hand, Lyon's right to the use of the building during that period is crucial to the Government theory of a flat six percent return. It is during this final period, the Government maintains, that Lyon is able to make up the difference between the rental provided for in the lease agreement and the amount necessary to bring its return of the $500,000 equity investment up to six percent. *Id.* at n. 26.[4] On the other hand, the Government sees the obvious danger to its "conduit" construction in Lyon's free rights to use the building for ten years. Accordingly, the government implies that the building is likely to be completely depreciated in value by that time, in effect, that all return in that period is hypothetical and irrelevant to the nature of the transaction. *Id.* at n. 25. This line of argument, of course, flatly contradicts the notions that the rental paid during the renewal terms were bargain rentals, and that return during the ten year period following the expiration of the building lease was an important part of the understanding; the Government cannot have it both ways.[5]

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[4] The Government has adopted this reconciliation of the ten-year period from the opinion of the Court of Appeals. Pet. App. 19a.

[5] The Government also errs in asserting that "the ground lease would terminate *if Worthen did not renew the building lease* or if it exercised its option to purchase the building (P. Ex. 18, Sec. 9, II-A, II App. 369)." Govt. Br. 13, n. 12; emphasis added. The cited section 9 of the Ground Lease provides that the ground lease will terminate only upon termination of the Building Lease pursuant to Worthen's purchase of the building in the event of damage or destruction (Article XVII), condemnation (Article XVIII) or exercise of options to purchase at the end of the 11th, 15th, 20th or 25th year of the lease (Article XX).

IV.

THE GOVERNMENT'S UNSUPPORTED FACTUAL ASSERTIONS ABOUT OPTION PRICES AND RENTALS ARE CONTRADICTED BY THE RECORD, THE DISTRICT COURT DECISION, AND THE PRECEDENT UPON WHICH THE GOVERNMENT RELIES.

A. At this advanced stage of the litigation, the Government has come up with yet another formulation of the "substance" of this transaction with which it attempts to rationalize the Court of Appeals' decision. The Government again asserts that its position is purely legal and derived from interpretation of the documents, though it depends on unsupported assertions about what is "likely" to happen to the building, to the parties, and to values, and about the relationship between market values and option prices and rentals.[6]

The newest formulation of the transaction designed to cast Worthen as the tax owner focuses on the renewal rentals to be paid after the initial term of the lease has ended. Govt. Br. 44-52. Since these are supposedly "bargain" or "nominal" rentals, the indication is that Worthen has purchased an equity in the building through its payments during the initial term.

[6] The Government has also introduced for consideration FASB Statement of Financial Accounting Standards No. 13, Accounting For Leases (November 1976). Govt. Br. 49-52. By its own terms, however, this statement does not have any relationship to the issue of tax treatment; the Board rejected tax treatment as a guide, ¶ 71, and conformity of tax and accounting treatment as a consideration, ¶ 78. Under FASB 13, there are instances in which a lease would be a "capital lease" ("This is not to say, however, that such transactions are necessarily 'in substance purchases' as that term is used in previous authoritative [accounting] literature." Id. at ¶ 60), but would still qualify for an advance ruling as a bona fide lease for tax purposes under *Rev. Proc.* 75-21. Compare Section 4(1)(C) of *Rev. Proc.* 75-21 with paragraph 7(c) of FASB 13.

The Government relies on characterizations of these rents as "favorable" and "very cheap" made by the independent realty witness and the president of Worthen Bank respectively. Id. at 46. The Government asserts that the district court failed to make a finding on the crucial issue of the relationship between renewal rentals and fair market price, and that the bargain rentals undermine any contention that Worthen is not the real owner of the building.

The findings of reasonableness made by the district court relate to the rentals over the entire period.

> The evidence reflected, and the Court finds, that the rent to be paid by Worthen during the term of the lease is reasonable, *a fact not contested by defendant.*" Pet. App. 6a (emphasis added).

Evidence of all the rental terms was before the district court, including evidence which indicated that the decreasing rentals were related to the decreasing value of the building.[7] The difference between rentals for the primary term and those thereafter reflects a burden of depreciation borne by Lyon, rather than "equity" built up by Worthen. Brief of Petitioner at 28-34.[8]

[7] The renewal rentals were the result of competitive bidding between potential investors (I App. 77) and were considered by petitioner "to be fair and equitable in relation to the value of the building at that point" (I App. 27).

[8] *Midler Court Realty, Inc.* v. *Commissioner*, 521 F.2d 767 (3rd Cir. 1975) is cited by the Government, Br. at 49, for the proposition that unreasonably low renewal rentals deprive the lessor of ownership rights. The issue, however, in the *Midler* case was whether there was a premium included in the initial rent terms which were much higher than renewal rents. The *Midler* court rejected such reasoning based merely on a disparity; it concluded that the rents in both instances reflected fair market values and relied upon the fact that the transaction was arms-length. Disparity can be ex-

B. Both the factual and the legal basis for the Government's arguments that the renewals make Worthen the "owner" are extremely scanty.

The Government did not present any evidence below concerning the relationship between the lease rental and market values, although it now identifies this relationship as crucial under the precedents. Govt. Br. 42.[9] If, as the court indicated in *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976), cited in Govt. Br. 67, the crucial failure is the failure to show any relationship between the option prices and fair market value, then that failure is the failure of the Government and the court of appeals below rather than of the taxpayer as in the *Franklin* case.

Examination of the cases on which the Government relies in contending that Worthen is the owner because of bargain renewal rentals reveals a very different factual pattern from that presented here. Govt. Br. 49. The Government contends that the rents there and here are "nominal" but neglects to attach any specific meaning to that term. The principal cases relied upon,

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plained by other circumstances, there, 521 F.2d at 773, as here. See pp. 22-23, *infra*.

[9] The initial theory which underlay the determination of deficiency was totally different. The Government had calculated that Lyon's tax benefit would be greatest if the option was exercised at the end of the eleventh year. The Government assumed in calculating tax liability that this would be the case and argued the inevitability of this result at trial. See I App. 285-86, 293-94. Dispute centered on the reasonableness of the option and the likelihood of exercise of the options. Now that the Government has evolved a new theory, these factors are irrelevant. Although both theories rest upon the relationship between prices set in the contracts and fair market values, the Government never introduced any evidence whatever relating to either theory.

Starr's Estate v. *Commissioner*, 274 F.2d 294 (9th Cir. 1959), and *Mt. Mansfield Television, Inc.* v. *United States*, 239 F. Supp. 539 (D.Vt. 1964), affirmed, 342 F.2d 994 (2nd Cir. 1965), cert. denied, 382 U. S. 818, present a very different understanding of "nominal". In both of those cases the reduction in rent from the primary to the renewal term was over 90%. Moreover, in both of those cases the "lessor" had recovered his investment and an agreed percentage return by the end of the initial rental term.[10] Nominal rentals combined with prior recovery of investment indicated that the "lessor's" interest in the property was for all practical purposes limited entirely to the primary lease term, where recovery of investment and agreed return was achieved.

The situation is entirely different here because (1) the renewal period rentals are quite substantial—the net rental in the initial renewal term is $200,000 per annum or $1,000,000 over the 5 year period which is totally net to Lyon, and (2) Lyon will not achieve its "agreed return" of six percent unless the option is exercised or until after the time the building reverts to Lyon's use at the end of 65 years. Govt. Br. 40, n. 26. It is undeniable that Lyon has a continuing interest because, even in the Government's formulation, Lyon must depend upon the condition and use of the building free of the lease—the residual value of the building—in order to achieve its return.

C. Moreover, the Government attempts to indicate that the testimony of the independent realty consultant

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[10] See also *Frenzel* v. *Commissioner*, 1963 P-H Memo TC, ¶ 63, 276 (October 7, 1963) cited in the Brief of the Solicitor General at 49. The Government also cited *Midler Court Realty*, 521 F.2d 767, discussed at n. 8, supra.

—that the option prices were reasonable—was based on the artificially low renewal rents. But this assertion is refuted by consideration of the record; the Government has apparently confused testimony concerning two separate topics. Govt. Br. 45, citing I App. 241, 251. At I App. 241, Mr. Barnes was asked if the option prices were reasonable approximations of the fair market value of the building at the future dates in question, and whether the method of fixing option prices which was used was both common and reasonable. His reply to both questions was unhesitatingly affirmative. This line of questioning was conducted with reference to the value of the building as it presented itself to the parties at the time of negotiating the option prices, that is, without consideration of the value of the lease itself.

The later discussion, I App. 251, was quite different. The question was not the reasonableness of the option price, but whether Worthen was likely to exercise the option. The expert's opinion was that Worthen was not likely to do so because the rental terms were "favorable," or in other words that the present value of rentals over the extended term was less than the amount necessary to exercise the option.

D. The focus on the relationship between renewal rentals and fair market rental values is not entirely consistent with the Court of Appeals' decision which the Government is attempting to support. In identifying the factors which supposedly had the "cumulative effect" of depriving Lyon of a depreciable interest in the building, the court did not stress the factors now identified—the relation between market prices and rentals and option prices—as crucial at all. The Court of Appeals made no findings whatever concerning market value—which the Government nonetheless identifies as crucial—because to do so it would have had to overrule as clearly erroneous specific findings of the district court on the reasonable relationship between market values and options and rentals.

E. Finally, one of the most critical aspects of the "market value" question which the Government has consistently failed to recognize is that the value of the building—at the end of the 25-year term or at any time—may be different to Lyon, Worthen, and to various third parties depending on their circumstances. Having been rebuffed in its arguments that the level of the options first at 11 and then at 25 years economically compelled Worthen to exercise them, the Government now argues that the question of exercise of the option is "irrelevant". Govt. Br. 47. The theory is that bargain renewals allow Worthen to sublet the building at a profit whether it uses it or not. Govt. Br. 48. This suggestion, while ingenious, has never been brought forward before, and it has several flaws.

The renewal rentals are supposed to be a "bargain" but at the moment there is no indication of how much of a bargain the merchandise might be at that point. If the building had depreciated substantially, capital investment might well be necessary, and the profitability of a sublease would depend on the amount of investment necessary, the availability of capital, the return on alternate investments, the expense and difficulty of managing the building, and so forth. All of these issues are problematical at this point and the Government has certainly failed to present any substantial support for its particular hypothesis. The only two things which are clearly shown on the record are (1) the continuing capital problems of Worthen, and (2) the diminishing utility and repair of the building over time.

The contradictions and inconsistencies of the Government's position are understandable in light of the fact that the theory had to be built at such an advanced stage of the proceedings, and the Government could not rely upon any attempt below to lay factual foundation or explore the inconsistencies with precedent. Nonetheless, there is no more basis for accepting this formulation of the transaction than any of the others through which the Government has sifted in the attempt to justify its result.

V.

CONCLUSION

In sum the Government has failed to reconcile either the approach or the result of the court of appeals below with sound tax administration, the realities of the transaction, the precedent on which it relies, or the Government's own various formulations of the case. If the approach pressed by the Government is followed, it will mean that no question in this area can be settled until the final appellate court has spoken. Yet taxpayers must plan, and the Internal Revenue Service should be in a position to apply the law in at least a roughly predictable fashion. The Government gives no weight

to these objectives at any point in its brief."[11] Principled and orderly administration of the tax laws requires that the decision of the court of appeals be reversed, and the district court's decision allowing the deduction of depreciation and interest by the petitioner be affirmed.

Respectfully submitted,

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[11] It is startling that the Government argues that advance rulings and advice of counsel can dispel the uncertainty brought about by the holding below. Govt. Br. 59, n. 41. When citing Revenue Procedure 75-21, which the IRS has offered as guidance, the Government neglects to mention that this *Rev. Proc.* met with strong protest from the real estate industry, and that the IRS indicated that it would not be generally applied to real property, but that "some if not many of the ruling guidelines should be applicable." See Rosenberg and Weinstein, "Sale-Lease-backs: An Analysis of these Transactions after the Lyon Decision," 45 Journal of Taxation 146, 147 n. 1 (1976) (the authors characterize both the *Lyon* court and the IRS as "groping for guidelines").

In the instant litigation, the petitioner would have been unable to predict the position of the Government from one stage of the proceeding to the next. Advice of counsel, which petitioner of course sought, received, and followed, hardly solves these problems.

FOR ARGUMENT

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No. 76-624

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

FRANK LYON COMPANY, *Petitioner*
v.
THE UNITED STATES, *Respondent*

On a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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SUPPLEMENTAL MEMORANDUM FOR THE PETITIONER

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SUPPLEMENTAL MEMORANDUM FOR THE PETITIONER

In a supplemental memorandum, the Government has set forth a recent Third Circuit case, *Sun Oil Co.* v. *Commissioner*, No. 76-2388 (September 7, 1977). In this responding memorandum, the petitioner will undertake to show the fundamental differences between that case and this, and the reasons why the decision of the court in the *Sun Oil* case should not affect the decision here.

I

The *Sun Oil* case is a two-party case, like *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939). See Pet. Reply Br. 1-6. In *Sun Oil*, the tax-exempt pension trust lender, having large cash assets to invest, put up money, and did nothing else. It took no risk, it merely held the property as security for its claims, as did the bank in *Lazarus*.

The property involved in *Sun Oil* was "mostly unimproved" land (Supp. Mem. 4a), and thus essentially not subject to depreciation. Rentals were sufficient to amortize the investment of the trust in full over the twenty-five year term, with an interest rate which was low because of the tax-exempt status of the lessor-lender.[1] Renewal options were at low levels, bearing no relation to the fair market value of the land at the time of renewal. Most important, Sunray retained the prerogative of ending the lease on any site by making a "rejectable offer" to purchase the property at an amount equal to the present value of the rents plus enough to insure the trust a 5% return.[2] Supp. Mem. App. 7a. Such offers could be made at will if Sunray were going to discontinue the business use of the property, or on specific dates if Sunray merely determined that continued leasing was "unprofitable or unreasonable or unnecessary" in its sole judgment. In lieu of

[1] The agreed interest rate on the first block of 120 parcels was 4⅝% and the rate on the second block of 200 parcels was 5⅜%. Supp. Mem. App. 5a.

[2] If the "rejectable offer" was accepted, Sunray would buy the property at this agreed price. If it was rejected, the trust would remain the owner, and "Sunray would be released from its obligation to lease the property which it had offered to purchase." Supp. Mem. App. 7a-8a.

making a rejectable offer, Sunray had the power to substitute for the leased premises other land of equal value to be determined by Sunray's book value.

Sun Oil had made over 130 rejectable offers, all of which were accepted by the trust.

The court concluded, as this Court did in *Lazarus*, that the sales and leases back were financing arrangements, similar to mortgages, and thus that Sunray's "rental payments" were not deductible as such, though, of course, the interest element in them would be deductible.

II

The present case is a three-party case. Frank Lyon Co. was not a financing organization. It was an entrepreneur. New York Life provided the permanent financing, and like the trust in *Sun Oil*, was guaranteed full return of its money plus agreed interest over the twenty-five year primary lease term. Worthen Bank, the lessee, however, undertook no obligation to see that Lyon came out whole. At the end of the initial term of the Worthen bank lease, Frank Lyon Co. will have paid off the loan made to it by New York Life, but it will not have recovered its original cash investment of $500,000, and it will have paid out in taxes on building rentals an additional net amount of approximately $436,000. See P. Ex. 36 at App. 595. In terms of net cash position, Frank Lyon will still have nearly a million dollars invested in the building when the only binding portion of the lease has expired.

The four ways in which Frank Lyon Company can realize on its substantial investment all depend on an ownership interest in the building. These are:

(1) It can sell its interest at any time for what it can get. Pet. Br. 44; App. 261-62; P.Ex. 51 at App. 687.

(2) After the basic twenty-five year lease has expired, it may receive rent for the several renewal terms, if Worthen chooses to renew. But there is no guaranty that the renewal options will be exercised, either at the end of twenty-five years or at the end of any one or more of the renewal periods. Pet. Br. 29-33, 39-41.

(3) It may recover its investment with interest, if the purchase option is exercised. But the district court found, on evidence, that "it is most unlikely and improbable that Worthen will exercise its option to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods." Pet. App. 6a.

(4) If the options are not exercised and the lease is not renewed at any point—and Lyon can in no way require exercise of the options or renewal of the lease—then Lyon will continue to own the building and can realize on it what it can, by operation or sale.

To these should be added the ownership of the building during the eventual ten-year period after all extensions of the lease have expired. During this period, Frank Lyon Co. will—if it has not sold the building—own it outright with all of the benefits and burdens of ownership. At the close of the ten-year period, Frank Lyon Co. will still own the building, and will be entitled to equitable adjustment when the ground lease expires.

Thus, clearly Lyon has an ownership interest in the building. It must look to the continuing value of the property to protect its investment and to realize a return. It has no claim against Worthen after the initial

rental period has expired. Its protection is in its ownership interest in the building itself.

III

The circumstances in the *Sun Oil* case were not such that the parties were subjected to any unforeseeable or imponderable future contingencies. The option rights, "rejectable offer" provisions, and the "extraordinary" provision (Supp. Mem. App. 17a) which allowed Sunray to substitute land of equal book value to Sunray made it clear that Sunray was building up an equity in the properties. It could terminate the arrangement with the trust, and its obligation to pay rent, and take back the properties at any time within its own discretion, with only a small additional payment.[3] The court concluded that "the rights of substitution rendered illusory the lessor's rights to reject an offer." Supp. Mem. App. 18a.

As in the bank cases, discussed in Pet. Reply Br. at 9-11,[4] the unvarying history of the arrangement bore out the inference that Sunray *would inevitably reassume full ownership* and could do so *at any time*. The

[3] Similarly, the indifference of the trust to value apart from Sunray's repayment obligations is shown in the substitution provision. Equal book value has, of course, no relation to equal market value, but book value was the standard of exchange. Sunray could have exchanged a parcel with a market value of $1,000 for land worth $100,000 if the book value of the two parcels were the same. While this could undoubtedly have been a substantial financing convenience to Sunray, it is inconsistent with equity ownership by the trust.

[4] American National Bank of Austin v. United States, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819; Union Planters National Bank of Memphis v. United States, 426 F.2d 115, 117-18 (6th Cir. 1970), cert. denied, 400 U.S. 827.

court noted that it was extremely unlikely that the trust would take possession or control. Supp. Mem. App. 19a.[5] Either rent or purchase would retire the "loan" at the agreed interest rate. The asset itself would go to Sunray and, being "mostly unimproved" land, was essentially not subject to either depreciation or casualty.

Decreasing option prices and rentals for land, which does not depreciate, may well reflect increasing equity in the lessee, and no risk of loss for the lessor. The *Sun Oil* court emphasized the fact that inflation in the value of the land was the probable expectation but that the options and rentals showed the opposite trend. Supp. Mem. App. 23a. However, a pattern of decreasing option prices and rentals with regard to a depreciating asset, such as the Worthen building, is quite consistent with the decreasing value of the asset to the lessor; and the district court accordingly found that the rentals and option prices were reasonable. Pet. App. 6a.

Finally, although Sunray and the trust were not related parties, the fact that the trust which provided the funds was tax-exempt introduces an element which is absent from the transaction here, which involves two fully taxable commercial taxpayers. This brings into play a number of tax considerations which do not affect the Lyon situation. See Pet. Br. 17, and n.18.

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[5] This conclusion is supported by ¶ 12 of the Sunray lease which provided that Sunray retained all rights to present and future improvements. At the end of Worthen's lease, however, all improvements go to Lyon. See Pet. Br. 40; P. Ex. 19, section 8.1 at App. 382-383.

IV

The Third Circuit did not ignore or overturn basic findings of fact made below as the court below did here. Rather, the *Sun Oil* court has in effect distinguished *Lyon* and cases like it by emphasizing the fact that the rentals there were not related to the value of the property. Supp. Mem. App. 27a-28a. The court relied on (1) specific testimony offered by the Government's expert witness, and (2) the Tax Court's failure to make any findings of fact or conclusions of law concerning the reasonableness of primary or extended term rentals. Supp. Mem. App. 21a, n.9. To illustrate the contrast, the *Sun Oil* court cited *Leslie Co.* v. *Commissioner*, 539 F.2d 943 (3rd Cir. 1976), where the Tax Court had made findings on the reasonableness of the rents and the Third Circuit relied on the findings of the Tax Court. Supp. Mem. App. 21a.

In the case at bar, the district court expressly found that the rentals were reasonable. Pet. App. 6a. Moreover, the Government offered no evidence as to the value of the properties, or the reasonableness of the rentals; the only expert testimony was offered by Frank Lyon Company, and the testimony fully supported the district court's findings as to the reasonableness of the rents and option prices. See Pet. Br. 28-30, 48; Pet. Reply Br. 8-9, n.2, 18-24. At the trial here, the Government did not even contest this point, and the findings of the trier of fact went against it.

Since there were no such findings in the *Sun Oil* case, the Third Circuit was not in the position of overturning or disregarding crucial findings of the trial court in order to reach its conclusion.

V

In order to determine tax substance, the *Sun Oil* court compared the situation there to the "traditionally bargained for business relationships between owner and lessee." Supp. Mem. App. 13a. Whatever those relationships may have been in the *Sun Oil* case, it is clear that here the relationships between owner and lessee were "traditionally bargained for" in long negotiations, which left Lyon, the owner, with substantial risks of ownership. It is also clear that the incidence of depreciation and interest deductions were an important element in that bargaining. If Lyon had had any reason to know that it could not deduct interest and depreciation, it would necessarily have sought and obtained a larger rental. There was not here any effort to deduct the cost of nondepreciable land through rental payments, as in *Sun Oil*. The only property here was a building, fully depreciable; and both of the parties here were fully subject to the provisions of the income tax law. There was no bargaining of the tax exemption here, as in *Sun Oil*.[6] Parties to such a bonafide transaction as that involved here should be able to count on the arrangement as they have set it up and should not be left to the uncertainties of the eventual decision of the ultimate appellate court.

It is far more sound to relate the essence of the bargain directly to the applicable provisions of the tax law and their purposes. Thus in the case before the court, the tax independent considerations which moti-

[6] Another relevant factual distinction between *Lyon* and *Sun Oil* is the lease option provision in *Sun Oil* which was drafted to insure that the parties could unwind the transaction if the tax benefits they sought were not achieved. Supp. Mem. App. 17a.

vated and formed the transaction,[7] the fair values of the option prices and rentals, the unlikelihood that the options to buy would be exercised, and the very real risks and burdens of depreciation borne by Lyon, support its claim to depreciation deductions. (There would appear to be no conceivable basis on which its interest deductions can be disallowed, for it paid interest which it owed.) No similar considerations appeared in the *Sun Oil* case to support the taxpayer's contention that the rents involved there were an ordinary and necessary business expense.

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[7] This included the fact that Worthen here was precluded by applicable law and regulations from owning the building. See Pet. Br. 44-46; Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972). There was no factor of this sort in the *Sun Oil* case, where all of the elements, without exception, pointed to a purely financial arrangement.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE OF THE NATIONAL REALTY COMMITTEE ON BEHALF OF PETITIONER

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INDEX

	PAGE
Authorities Cited	i
Interest of the Amicus	1
The Decision Below	3
Summary of Argument	3
Argument:	
Bargained-For Business Relationships Between Owner-Lessors and Lessees Should Not Be Disturbed	4
(a) Net Lease Provisions	4
(b) Reasonable Rentals	6
(c) Options to Purchase At Fair Market Value	6
(d) The Investment Credit	8
(e) Absence of Cash Flow	8
(f) The Ground Lease	9
Conclusion	12

Authorities Cited

Cases:

Arkansas Bank and Trust Co. v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963)	6
Athenaise M. Hill, 63 T.C. 225 (1974)	8

PAGE

Benton v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952) 5
Breece Veneer & Panel Co. v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956) 5, 6, 7

Commissioner v. *Brown*, 380 U.S. 563 (1965) 5, 8

David F. Bolger, 59 T.C. 760 (1973) (*Acq.*) 8

Glynn W. Keeling, 30 CCH T.C.M. 954 (1971) 7

Kearney & Trecker Corp. v. *United States*, 195 F. Supp. 158 (E.D. Wis. 1961) 6
Kitchin v. *Commissioner*, 353 F.2d 13 (4th Cir. 1965) (*en banc*) 6

Lockhart Leasing Co., 54 T.C. 301 (1970), *aff'd*, 446 F.2d 269 (10th Cir. 1971) 7
LTV Corp., 63 T.C. 39 (1974) 6, 7

Manuel D. Mayerson, 47 T.C. 340 (1966) (*Acq.*) 8

Norman Baker Smith, 51 T.C. 429 (1968) 6, 7
Northwest Acceptance Corp., 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974) 6, 7

Reade Manufacturing Co., 32 CCH T.C.M. 1225 (1973) 6

Weiss v. *Weiner*, 279 U.S. 333 (1929) 9

Statute:

Section 48(d) of the Internal Revenue Code of 1954, as amended 8

PAGE

Treasury Regulations:

Treas. Reg. §1.48-4 8
Treas. Reg. §1.162-11(b)(1) 9
Treas. Reg. §1.178-1 9

Revenue Ruling:

Rev. Rul. 61-217, 1961-2 C.B. 49 9

Revenue Procedures:

Rev. Proc. 62-21, 1962-2 C.B. 418 9
Rev. Proc. 72-10, 1972-1 C.B. 721 9

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Interest of the Amicus

The National Realty Committee is a non-profit business league of real estate owners, builders, developers and investors with approximately 250 members throughout the United States. Its membership includes some of the largest and most important real estate firms in the industry. As part of its program of representing the real estate industry, it regularly monitors and responds to proposed changes in federal tax legislation affecting the industry and, on ap-

propriate occasions, presents the views of its members to the judicial, legislative and executive branches of government.

Deductions for income tax purposes of depreciation and interest are major economic incentives to real estate investment for a significant segment of the real estate industry. The decision of the court below disallows deductions traditionally enjoyed by owners of real property arising out of commercial arrangements negotiated at arm's length. The decision thus raises a doubt concerning the tax attributes of ownership of property held under long-term leases. This doubt is sufficient to impair the value and marketability of affected real estate. Since real estate investment requires substantial capital outlays, investors will be unwilling to invest when there is uncertainty concerning the tax attributes of the property being acquired.

If the tax deductions heretofore available to real estate owners cease to be available, lessors will require additional rent to compensate for the loss of economic benefits attributable to such deductions. Increases in rent will inevitably increase the cost of doing business, stimulate inflation and discourage business expansion.

The National Realty Committee believes that predictability of tax consequences of leasing arrangements is of major importance to the real estate industry and that the manner in which the instant case is decided will have an important impact on the growth and stability of a significant portion of the industry.

The Decision Below

The court below, reversing the District Court, held that a sale by Worthen Bank & Trust Company ("Worthen"), of a building (the "Property") to Frank Lyon Company ("Taxpayer"), followed by a long-term leaseback of the Property, constituted a loan and not a sale and lease. The court below held further that since the Taxpayer did not become the owner of the Property for federal income tax purposes, it was not entitled to deductions for depreciation and interest with respect to the Property. By so doing, the court below altered the economic benefits of the ownership of property bargained for in arm's length negotiations.

Summary of Argument

The tax attributes of ownership of property are economic rights. The allocation of those rights when they reflect common commercial practice and are derived from agreements negotiated at arm's length should not be disturbed unless there is an overriding policy consideration which would warrant such action. The decision of the court below suggests no such overriding policy. To shift the tax attributes of ownership in this case will disrupt the bargained-for economic arrangements, resulting in a loss to Taxpayer and a windfall to Worthen. If the decision of the court below is allowed to stand, there may be a severe disruption of the economic relationships between lessors and lessees under long-term leases.

ARGUMENT

Bargained-For Business Relationships Between Owner-Lessors and Lessees Should Not Be Disturbed.

The court below held that the sale and leaseback entered into by Taxpayer and Worthen, bargained for at arm's length, should be characterized as a loan. This conclusion was based in large part on provisions in the lease which are common in lessor-lessee relationships: "net" rent at reasonable rates; options to purchase for amounts the parties estimated to be fair market value; and allocation of the investment credit to the lessee. The court below also relied on the absence of annual cash flow and the fact that Taxpayer leased the underlying land from Worthen. The District Court found that none of these factors were indicia of ownership by Worthen. Examining these factors in their business context reveals that they are based on sound business considerations in the lessor-lessee relationship and their presence in a sale and leaseback should not be grounds for rearranging the normal tax consequences of the lessor-lessee relationship.

(a) *Net Lease Provisions.*

There is no economic difference between a gross lease and a net lease. In a gross lease, fixed rentals are determined by including in the gross rent the projected expenses with respect to the leased property, such as utilities, insurance and real estate taxes. Net leases, on the other hand, provide for lower fixed rents, but require the lessee to pay operating expenses directly. In both cases,

the lessee pays for such costs, either directly or indirectly. It is common for gross leases to have escalation clauses providing for increased rents tied to increased costs so that the net rent received by an owner-lessor will not decrease. Owners generally are unwilling to assume open-ended obligations to pay for increased costs over a long period. With net leases the owner is assured of the agreed net return on his investment throughout the lease term.

Net leases characteristically involve a shifting of risk from lessor to lessee. The reliance by the court below on the presence of a net lease to conclude that a bona fide sale and leaseback had not occurred is in direct conflict with *Commissioner* v. *Brown*, 380 U.S. 563 (1965), where this Court specifically rejected the argument, in a sale and leaseback transaction, that the absence of risk shifting affected the bona fides of the transaction. The District Court, consistently with *Brown*, correctly attributed no significance to the presence of a net lease:

> The agreement of Worthen, as lessee under the Building Lease, to pay all taxes, insurance and maintenance on the building, to hold the lessor harmless from all claims arising out of lessee's use of the premises and to pay rent during the initial term in an amount sufficient to amortize the mortgage on the building are all terms which are quite common in long-term real estate leases.

Appendix to Certiorari Petition ("Cert. Pet. Appx.") at 12a. In so doing, the District Court reached the same result as have many other courts. *See, e.g., Breece Veneer & Panel Co.* v. *Commissioner*, 232 F.2d 319, 320 (7th Cir. 1956); *Benton* v. *Commissioner*, 197 F.2d 745, 748 (5th Cir.

1952); *Arkansas Bank and Trust Co.* v. *United States,* 224 F. Supp. 171, 174 (W.D. Ark. 1963); *Kearney & Trecker Corp.* v. *United States,* 195 F. Supp. 158, 161 (E.D. Wis. 1961); *LTV Corp.,* 63 T.C. 39, 49-50 (1974); *Northwest Acceptance Corp.,* 58 T.C. 836, 839 (1972), *aff'd,* 500 F.2d 1222 (9th Cir. 1974); *Norman Baker Smith,* 51 T.C. 429, 432 (1968); *Reade Manufacturing Co.,* 32 CCH T.C.M. 1225, 1229-30 (1973).

(b) *Reasonable Rentals.*

Where rents have been reasonable the courts have found true lessor-lessee relationships. *Kitchin* v. *Commissioner,* 353 F.2d 13, 15 (4th Cir. 1965) (*en banc*); *Breece Veneer & Panel Co., supra,* 232 F.2d at 322. Reasonable rent cannot be determined solely on the basis of a comparative analysis of costs per square foot in a given area. Rent depends upon a variety of factors including, among others, the ability of the lessor to finance on the basis of the quality of the lessee, the terms of the lease and the intrinsic value of the property. These factors affect rent because they affect the lessor's borrowing costs.

When a seller leases back the conveyed property, if the rents are reasonable, the purchaser-lessor can take advantage of a variance in interest rates to refinance his cost of acquisition and dramatically increase his annual cash flow from the property.

(c) *Options to Purchase at Fair Market Value.*

It is not uncommon for owners to grant lessees options to purchase leased property. Lessees seek such options, for example, because particular properties through a long course of business dealings in a community establish values to such lessees over and above the intrinsic

value of the real estate. Thus, a lessee may wish to purchase a property to preserve the good will established in a particular locality. If the option price is at fair market value, the owner will receive the full value of his property.

An option to purchase at a price estimated, at the time the lease is made, to be fair market value when it is to be exercised (in contrast to a price estimated to be nominal at that time) has been held to be indicative of ownership by the lessor, and not the lessee. *See, e.g., LTV Corp., supra,* 63 T.C. at 50.

Similarly, a fixed substantial option price even if it is less than fair market value is also consistent with lessor ownership since it is not certain that the option will be exercised. *See Breece Veneer & Panel Co., supra,* 232 F.2d at 322; *Northwest Acceptance Corp., supra,* 58 T.C. at 847-48; *Lockhart Leasing Co.,* 54 T.C. 301, 314 (1970), *aff'd,* 446 F.2d 269 (10th Cir. 1971); *Norman Baker Smith, supra,* 51 T.C. at 439; *Glynn W. Keeling,* 30 CCH T.C.M. 954, 959 (1971). The option price is often determined by the relative bargaining strengths of the parties; it is not indicative of a financing unless it is so nominal that the lessee is economically "compelled" to exercise.

Here, the District Court found as a fact that the option price "represent[ed] the negotiated estimate of [the parties] as to the fair market value of the building on the option dates", and that such estimate was "reasonable". Cert. Pet. Appx. at 6a. Although an unrealistically low option price indicates economic compulsion of reacquisition by the lessee, no such compulsion exists when the option price approximates fair market value. Under these

circumstances, the court below erred in relying on the options to purchase in reaching its decision.

(d) *The Investment Credit.*

The court below, without explanation, considered relevant the fact that Worthen retained the investment credit stemming from the construction of the Property. However, since section 48(d) of the Internal Revenue Code of 1954, as amended, (the "Code"), and Treasury Regulation §1.48-4, expressly authorize a lessor to assign the investment credit to its lessee, this factor can in no way be relevant to the question whether the transaction is a sale and leaseback or a loan.

(e) *Absence of Cash Flow.*

The court below noted that during the initial 25-year term of the lease the rents received exactly equalled the payments necessary to satisfy debt service on the mortgage. This reflects nothing more than the extent to which the purchase of the building was financed and was not indicative of a debtor-creditor relationship between the Taxpayer and Worthen. *See Brown, supra. Cf. Manuel D. Mayerson,* 47 T.C. 340 (1966) (*Acq.*).

In this regard the language of the court in *Athenaise M. Hill,* 63 T.C. 225, 243 (1974), is apposite:

> [W]hile there would be no positive cash flow from the property [for twenty years] the [taxpayers] could foresee over such period, the gradual buildup in their equity in a valuable piece of property . . . .

Here, Taxpayer will own the Property unencumbered after the initial 25-year lease term. *See also David F. Bolger,* 59 T.C. 760 (1973) (*Acq.*).

Furthermore, Taxpayer, not Worthen, has the right to satisfy or refinance the indebtedness. The right to refinance allows Taxpayer to obtain the benefit of a decline in interest rates, either by an immediate cash return or by increased cash flow from the reduction in debt service.

(f) *The Ground Lease.*

One of the most common divisions of interests in property is that between ground lessor and ground lessee. As this Court has recognized in *Weiss* v. *Weiner,* 279 U.S. 333 (1929), and the Commissioner has recognized in Rev. Rul. 61-217, 1961-2 C.B. 49, as between lessor and lessee, the party with the monetary investment in an improvement has the right to depreciate it. The Treasury has specifically recognized that if a lessee constructs improvements on leased land, it is the lessee, not the lessor, who is entitled to depreciate the improvements. Treas. Reg. §1.162-11(b)(1); Treas. Reg. §1.178-1.

The Commissioner in Rev. Rul. 61-217, *supra,* ruled that where a lessee of land constructs improvements on the land and sells those improvements to a third party, the purchaser, *not* the landowner, is entitled to depreciate those improvements. Therefore, the fact that Worthen continued to own the land after selling the improvements to Taxpayer has no relevance to a determination of which party is entitled to depreciate the Property.

Further, it is highly unlikely that Worthen will acquire the existing building at the end of the 76-year ground lease term. In both Rev. Proc. 62-21, 1962-2 C.B. 418, 420 and Rev. Proc. 72-10, 1972-1 C.B. 721, 731, the Service suggested a 45-year useful life for office buildings. Thus, it

is highly probable that the economic life of the building will be exhausted during the ground lease term. Taxpayer, therefore, will bear the burden of depreciation of the building. Accordingly, the reliance of the court below on the existence of the ground lease was misplaced.

If the foregoing factors were permitted to serve as a basis for treating lessees as owners of real property, many existing economic arrangements which were the result of bargains between owners and lessees will be altered. Lessees will reap an after-tax windfall by being entitled to deductions with respect to property owned by their lessors, and lessors will suffer a significant reduction in economic benefits to be derived from their property. The values of the properties affected will fall. This is particularly so with respect to properties with long-term leases. A long-term reduction of benefits to be derived from a particular parcel of realty will necessarily impair values. Such a rearrangement of economic relationships should not be brought about by either administrative or judicial determinations.

The inability of owners of real property to realize benefits heretofore anticipated from such ownership will also impede the acquisition and development of real estate, unless compensatory benefits are provided by way of additional rent. Since increased rent will inevitably increase the cost of doing business, it will serve to discourage a significant number of business enterprises.

Nowhere has it been or could it be shown that these consequences were contemplated by Congress. They should

not be imposed on the real estate industry in particular, and business in general, either by the Commissioner or by judicial fiat, unless an overriding public policy justifies such action. No such public policy has been demonstrated.

The real estate industry is a capital intensive industry which historically has required reasonable opportunities for capital cost recovery in order to attract necessary capital. The Code provides for this principally through provisions permitting an owner of improved real property to recover its cost through deductions for depreciation over the useful life of the improvements.

CONCLUSION

Tax consequences are an intrinsic element of the economics of all business transactions. Therefore, predictability of tax consequences in traditional relationships between lessors and lessees is of major importance to the real estate industry and to business development in general. The decision of the court below, since it disrupts economic consequences of relationships arrived at as the result of arm's length bargaining, should be reversed.

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